The Law of First Impressions
A Practical Guide to Mortgage Applicants

Increased Importance of Borrower Financial Statements For Commercial Real Estate Financing

Robert T. Gibney

Real estate investors prepare and submit financial statements to two powerful groups that are critical to their success or failure: the Internal Revenue Service and their real estate lenders. Consider the amount of time and money invested annually in the planning and preparation of federal income tax returns. The planning and preparation of an income tax return may include the services of bookkeepers, controllers, chief financial officers, auditors, and accountants. Each professional strives to compile accurate data and to comply with the complex federal tax code in order to avoid civil and criminal penalties. In addition to the cost associated with these professionals, each taxpayer devotes significant time during the year to reviewing year-to-date financial statements in order to estimate current-year tax liability and to pay estimated income taxes.

In comparison, real estate lenders are rarely given the same degree of care and attention by borrowers who submit financial statements and real estate schedules. A borrower's responsibility for filing complete and accurate financial statements does not end at loan funding. Many real estate loan documents require the borrower to submit updated financial statements and real estate schedules every year. Many loan documents require borrowers to maintain a minimal level of net worth, income, and liquidity during the term of the loan.

FINANCIAL STATEMENT UNDERWRITING

Real estate lenders prepare a thorough review and analysis of the borrower's personal and business financial condition prior to issuing new credit, or prior to agreeing to a loan workout, modification, or term extension. At worst, the failure to provide accurate and complete financial data to a lender may result in a declined loan application, failure to negotiate a loan workout/modification, and even civil or criminal liability. Borrowers who submit inaccurate or incomplete financial statements may incur civil or criminal liability. At best, incomplete or inaccurate financial statements may result in added delays and increased expenses as the lender attempts to re-construct the borrower's financial statement in order to create a realistic statement of the borrower's financial condition.

Recourse lenders rely on the borrower's personal guaranty, in addition to the collateral, when underwriting requests for financing. Although the subject property is the primary source of repayment, the borrower provides additional credit strength to the lender. The subject property provides cash flow to service the debt as well as value to serve as collateral in the event of default by the borrower. Although it is common knowledge that a recourse lender underwrites loans based on the borrower's assets, net worth, and cash flow, many borrowers fail to devote adequate time and attention to the preparation of business and personal financial statements.

Submitting a financial statement to a lender is an opportunity to make a positive first impression. As with the preparation of income tax returns, a borrower's investment in time and attention to the preparation of financial statements and supporting documents will result in a more positive response from lenders.

UNDERWRITING DURING THE PEAK YEARS

During the recent period of rapid property appreciation (2002-2007), many lenders accepted incomplete and inaccurate financial statements from mortgage applicants. As a result, borrowers were able to over-state their liquidity, net worth, and income with little lender scrutiny. For the average mortgage applicant, stock investment accounts were listed at ever-increasing market values. Various categories of Illiquid assets (shares in private partnerships, business net worth, stock in non-traded corporations, etc.) were listed as marketable securities. These types of assets are not readily marketable, and when they are sold they tend to be sold at large discounts. Real estate schedules listed properties with inflated market values based on unsubstantiated valuation assumptions. A property purchased for $1,000,000 in 2004 may have been listed at a value of $2,000,000 in 2006. Many mortgage applicants did not disclose the cap rate used to estimate the current market value. In fact, many properties were listed at unrealistic cap rates. In addition, properties were listed with overstated rental income and net operating income. Little consideration was given to the cost basis of each property. Short-term land loans with high loan-to-value ratios were not addressed. It was assumed that the land would be sold for a profit, or refinanced prior to the loan maturity. Capital gains were reported as ordinary income, despite the fact that capital gains are non-recurring cash flows. During this period, many real estate investors gave up their "day job" to devote 100% of their time to real estate investing, assuming that capital gains would continue to be a reliable source of income.

The cumulative effect of these inaccuracies resulted in an overstatement of the mortgage applicant's liquidity, net worth, and income. Underwriters, who relied on these inaccurate financial statements to make credit decisions, over-estimated the ability of the borrower to provide secondary sources of loan repayment.

UNDERWRITING DURING THE DOWNTURN

As the market enters a long-term recessionary period, lenders have responded by expanding the scope of their financial statement review and analysis. Many responsible lenders have established credit policies and procedures designed to "re-construct" each mortgage applicant's financial statement. The process requires the underwriter to review and analyze each asset and liability to verify the stated ownership interest of each asset, and the marketability and value of each asset using current market valuation methods. The revised financial statement is frequently unrecognizable when compared to the original financial statement as submitted by the mortgage applicant.

A current, complete, and accurate financial statement is a critical part of the loan application or modification – workout process. In addition, as property values continue to decline, lenders are increasing their reliance on the ability of the borrower to supplement the property cash flow with income derived from other sources.

This increased level of due diligence is intended to identify any potential weaknesses in the borrower's financial condition that may develop during the term of the loan. The areas of increased analysis include liquidity, global cash flow, and real estate equity.

Liquidity

Liquid Assets are generally defined as cash, marketable securities, and other assets that can be converted to cash on demand. Examples include bank accounts (savings, checking, and money market accounts) and brokerage accounts. It should be noted that the steep decline in stock valuation in 2008 has reduced many stock investment account by 30-50 percent. Lenders require the past 2-3 recent account statements to verify the current value of bank deposits and marketable securities. Liquid assets do not include equity in businesses and private partnerships that are not readily marketable. Borrowers should have liquid assets in proportion to their net worth. For example, a mortgage applicant with a net worth of $3,500,000 and liquid assets of $100,000 would be considered under-capitalized.

Lenders are interested in determining "pre-closing" liquidity to verify the source of the down payment. When multiple investors are providing cash equity, each investor is required to disclose the percentage of the down payment that is being paid. Borrowed funds that are used for equity investment need to be disclosed to the new lender. Use of lines of credit or other refinancing transactions result in increased liabilities and debt service. This level of detail was frequently overlooked in the boom years.

Determining the borrower's "post-closing" liquidity is an important part of the underwriting process. How much liquidity will the borrower have after the loan has closed to cover short-term demands for cash? Are there any loans that mature in the next 12-24 months? What is the risk of a decline in liquidity resulting from a continued decline in the stock market?

It is advisable for each real estate investor to conduct a regular analysis of available working capital. Businesses conduct an ongoing evaluation of their ability to raise cash: the difference between short-term assets and short-term liabilities. Consideration is given to any debts that are payable in the next twelve months, including accounts payable, income taxes, and maturing loans. For example, it is assumed that a borrower's cash may be needed to repay all or a portion of a maturing land loan, since new financing may not be readily available. Real estate partnership "cash calls" are another potential drain on liquidity. Some cash calls may require payment in 30 days.

Many loan documents include covenants that require the borrower to maintain a minimum amount of liquid assets during the term of the loan. Failure to conform to the covenants as stated in the loan documents (liquidity, property occupancy and debt coverage ratio, etc.) may result in a non-monetary default.

Global Cash Flow

Lenders have responded to the current real estate market by implementing a more detailed review of each mortgage applicant's cash flow. A personal or business cash flow analysis considers the historical and current net cash flow (including income, cash expenses, and non-cash adjustments of depreciation and amortization). A global cash flow analysis provides a lender with a more comprehensive evaluation of a mortgage applicant's overall cash flow position by including the net cash flow of each property and partnership investment.

Underwriters pay close attention to all business, real estate and partnership investments:

- Determine the net cash flow for each income property based on the prior year's income tax returns and current rent roll and operating statement
- Verify any future changes in loan terms for each real estate investment that may result in increased debt service (i.e. fixed rate loans that convert to adjustable rates after the first 3-5 years)
- Estimate any potential "cash calls" that may be payable to fund real estate partnerships, capital improvements or working capital accounts
- Determine the global debt coverage ratio
- Determine the historical trend of the mortgage applicants global cash flow
- Track historical changes in accounts receivable and accounts payable

Underwriters rely on federal income tax returns to verify a mortgage applicant's historical income and expenses. Federal income tax returns are considered to be more accurate than a year-end property operating statement or business profit and loss statement. Mortgage applicants should address and explain any differences between their tax returns and year-end financial statements. In response to the declining economic conditions, many lenders are not accepting IRS extension requests after the filing deadline of April 15.

The global cash flow method of underwriting provides lenders with a more accurate assessment of the borrower's overall financial condition and the secondary source of loan repayment. Although many lenders use a proprietary approach to global cash flow analysis, this summary should be useful as a guide to mortgage applicants.

Real Estate Equity

An important component of the net worth analysis is a review of the mortgage applicant's real estate schedule. The efficiency of the loan underwriting process would be improved if mortgage applicants adopted a standardized format for the real estate schedule. Each property should be listed with the following information:

- Accurate property value based on current market conditions – state the cap rate used for each listed property
- Date of acquisition and original purchase price
- Net Operating Income – based on actual rental income and operating expenses
- Loan terms (i.e. fixed or adjustable, interest rate, payment, balloon payments)
- Types of property – single and multi-tenant income property and land
- Percent ownership
- Type of ownership entity and number of other owners – the structure of TIC investments and other investment entities with multiple investors have exhibited some stress in the current real estate market
- Current rent roll for each income property, which includes the name of each tenant, lease terms, and options to renew (indicate vacant space)
- Net equity should include capital gains tax payable based on the current market value, original cost basis LESS the recapture of accumulated depreciation

When several investment partners are submitting financial statements and real estate schedules to a lender, care should be taken that each partner lists the same data for properties that are co-owned. It is not uncommon for the same property to be listed by two investment partners with different value estimates.

Mortgage applicants should consider an additional factor related to the increased importance of accurate and complete financial statements: potential civil and criminal liability.

REPRESENTATIONS AND WARRANTIES

Mortgage applicants should be aware of the representation and warranty language included in many financial statements:

> "The information contained in this statement is provided to induce you to extend or to continue the extension of credit to the undersigned or to others upon the guaranty of the undersigned. The undersigned acknowledge and understand that you are relying on the information provided herein in deciding to grant or continue credit or to accept a guaranty thereof. Each of the undersigned represents, warrants, and certifies that the information provided herein is true, correct, and complete. Each of the undersigned agrees to notify you in writing of any change in name, address, or employment and of any material change (1) in the undersigned's capacity to perform its obligations to you or (2) in the financial condition of any of the undersigned. In the absence of such notice or a new and full written statement, this should be considered as a continuing statement and substantially correct. As long as any obligation or guaranty of the undersigned to you is outstanding, the undersigned shall supply annually an updated financial statement."

The borrower's representations and warranties are statements of fact concerning the borrower's financial condition and the guaranty of the borrower that the facts are completely true. Lenders are entitled to rely and will rely on the representations and warranties to extend the requested financing. If the representations and warranties are subsequently shown to have been false, the lender has claims against the borrower for breach of contract and fraud, as well as possibly others. Fraud claims may not be dischargeable in bankruptcy if the borrower subsequently faces that possibility. Accordingly, as with the other aspects of the financial statements discussed above, borrowers must take special care to assure that the statements made in representations and warranties are absolutely true. If not, especially in the current environment, the commitment the borrower thought it had may be revoked. Thus, the need for complete and accurate personal financial statements extends to all phases of the lending process; new loan applications, loan commitments, and annual reporting as required by lenders.

Mortgage applications are receiving increased scrutiny by lenders as mandated by a newly organized federal agency, The Financial Crimes Enforcement Network (FinCEN). The FinCEN report dated March 2009 ("Mortgage Loan Fraud Connections with Other Financial Crime") states, "The purpose of this study is to better understand the relationship between mortgage loan fraud and other financial crime…Mortgage loan fraud involves intentional misrepresentations to a lender for the purpose of obtaining a loan that would otherwise not be advanced by the lender." Although the focus of this study is residential mortgage fraud, commercial real estate mortgage applicants should be aware that banks are applying the same verification and enforcement procedures to all new loan requests.

LAW OF FIRST IMPRESSIONS

By following the general and specific guidelines included above, mortgage applicants will avoid violating the law of first impressions. When beginning the underwriting process, real estate lenders are strongly influenced by the preliminary review of the mortgage applicant's financial statements. Inaccurate and incomplete financial statements may cause underwriters to question other aspects of the loan application. For example, if the subject property value is grossly inflated, the underwriter may question the accuracy of the other financial statement data. Incomplete or inaccurate financial statements tend to undermine other positive aspects of a borrower's loan application. While banks may have overlooked financial statement inaccuracies and omissions in the past, mortgage applicants need to be aware of the changing underwriting and regulatory environment as they work with their lenders in these challenging times.

COMMERCIAL MORTGAGE CONSULTING

Robert T. Gibney & Associates is available to assist lenders, mortgage applicants, and existing borrowers as they adjust to the new realities of the commercial real estate lending market. By working together, we can ensure that the loan application and financial statements are an accurate representation of the borrower and property. Working directly with a lender, without the expertise of a commercial mortgage broker or consultant, may have been a successful strategy during the boom years. Whether applying for a new loan, or requesting a loan workout or modification, an experienced commercial mortgage broker-consultant will increase the probability of success and improve the efficiency of the underwriting process.

Robert T. Gibney
Commercial Financing and Mortgage Consulting Services
4300 N. Miller Road, Suite 212
Scottsdale, AZ 85251
Office 480 429-3642
Email Rgibney@AZCommercial.biz
www.azcommercial.biz
Arizona Mortgage Broker # MB 0904411

Thanks to Joseph Kruchek for his contributions to the Representation and Warranty Section:

Joseph Wm. Kruchek
Kutak Rock LLP
8601 North Scottsdale Road, Suite 300
Scottsdale, Arizona 85253-2742
Direct: 480-429-4889
Mail: 480-429-5000
Facsimile: 480-429-5001
Joe.Kruchek@KutakRock.com