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Hard-money loan: What is it, what's the key to underwriting?

Ever wonder what the magic formula is to get a hard-money loan funded? There is quite a bit of misconception about how a hard-money lender (private lender, bridge lender, etc.) underwrites its commercial loans. Many believe that there is a magic formula hard-money lenders use in order to determine which loans to fund. Unfortunately there is no magic formula since each transaction is unique. In this article I will discuss the basics of hard-money underwriting and how this differs from a conventional lender. Before beginning, it is important to note that there are very big differences in how a hard-money lender underwrites versus a conventional lender (bank, credit union, etc.).

In order to fully discuss the differences in underwriting guidelines, it is important to define what a hard-money loan is (these loans are commonly referred to as bridge loans, private loans, etc.). A hard-money loan in its simplest terms is a loan backed by a hard asset. Traditionally this asset is real estate (either residential or commercial). The lender focuses heavily, if not solely, on the value of the asset. So the next question is how is a hard-money loan different than a conventional mortgage?

Prior to beginning a conventional loan, a lender will request a plethora of documents including personal and corporate tax returns, income statements, leases, prior appraisals, environmental assessment (typically a phase one is required for most lenders) and countless other documents. A conventional lender underwrites radically different than a commercial hard-money lender. A conventional lender focuses heavily on the borrower's credit (traditionally above a 700 FICO), a borrower's debt-to-income ratio, the borrower's overall net worth, and finally the value of the property. The value is determined by an appraiser chosen by the bank. The appraisal is traditionally done by a member of the Appraisal Institute (or MAI) who focuses on commercial real estate. These appraisals take anywhere from two to five weeks historically.

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Most conventional lenders are looking for "plain vanilla" properties that are currently income producing. Many lenders are focusing on Class A and B properties with little interest in properties that do not meet these criteria. Many conventional lenders have rigid guidelines that a loan must fit into in order to get funded. Substantial deviation from these guidelines is typically not allowed.

Hard-money lending is radically different than conventional lending. Hard-money lenders are typically privately funded, which allows greater flexibility on funding loans. A hard-money lender focuses heavily (in many cases almost solely) on the value of the hard asset that will be secured by the mortgage. This allows a hard-money lender to fund a loan to a borrower with less than perfect credit, financials, etc. Since a lender is focusing primarily on the property, typically it can close and fund a loan in as little as a week or two.

Some hard-money lenders rely on an appraiser similar to a bank. Many lenders rely on internal underwriting of a property to determine a property value. This value is determined by one of two valuation methods (the income approach or the sales comparable approach). Hard-money lenders rarely use the cost approach to valuing a property since they are more concerned with what a property would sell for today as opposed to what a property could be rebuilt for. Since a hard-money lender is relying so heavily on the property's valuation, it is typically conservative in its use of each of these methods.

First, on the income approach a hard-money lender will look at both the current leases along with what the current market rents are. If there are shorter-term tenants with leases above market, then the leases are typically discounted to what is considered a quick lease-up rate on a property. This methodology can be used in the reverse as well. I have funded transactions where the leases were substantially below market for various legitimate reasons. When the property was evaluated on its income, the property value was substantially less than the market value. A hard-money lender typically is able to develop a pro forma of what the current market is to ascertain the true market value of the property. The lender makes assumptions on vacancy, management fees, etc., if these items are not available. This information is compiled and utilized along with a reasonable capitalization rate to determine the property's value.

Second, on the comparable approach to valuation, a hard-money lender will look at recent sales of similar property type in a very close proximity to the subject. These sales typically will include distressed sales, which in many cases reduce the valuation of the property. The typical lender also will look at current listings to get a feel for the market and the property valuation (i.e., if the property next door to the subject is listed and it is comparable to the subject.) This listing will be a good basis for determining the current market value of the property. Ultimately the hard-money lender is trying to evaluate what the property would sell for in a reasonably quick time frame.

Based on the two methods above, the hard-money lender is able to determine what it feels is the true quick sale market value of the property. The hard-money lender almost always will err on the conservative side on its valuation since at the end of the day it is relying on the property for its repayment.

Conventional loan underwriting has been substantially more rigid since the last recession. Fortunately, a hard-money lender has the ability to think outside the box in underwriting a loan. This allows the hard-money lender to fund many deals that are not fundable by traditional lending sources and provide borrowers alternative avenues to capital.▲