Commercial Mortgage Insight®

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Hard Money: Top Three Lingering Inquiries

During a time when slowing down and cutting back dominate most commercial mortgage finance trends, hard money is currently enjoying an expanded and active role. (See "Why Hard Money Now Rules" in the October 2008 issue of ***Commercial Mortgage Insight.***)

For further details on the status of this specialized form of financing - particularly in the wake of the latest developments from Wall Street - we checked in with industry veteran Ira Bergstein, chief financial officer at Palisades Financial.

Ira Bergstein

1. We have seen some overlap on industry players' working definitions of hard money, private capital, bridge financing and even asset-based financing. What are the important distinctions to keep in mind?

Bergstein stresses that asset-based financing should be considered a separate category, as it involves such non-real-estate domains as accounts receivable, inventory, machinery and so on.

On the strictly real estate side, bridge loans might also be distanced from the pack, because their identity depends only on the time period of the loan rather than on the source of capital.

Hard money and private capital are officially the most similar, according to Bergstein. "Private capital is the same as hard money - it's just less organized," he explains. "It's more like equity than anything else. You're not going to be well represented by lawyers."

2. Within the specific realm of hard money/private capital, what important variations exist among shops? What are the advantages and disadvantages of each?

"I like to differentiate hard-money lenders into two groups," says Bergstein. "There are certain hard-money lenders that are what I call loan-to-own shops, and their intention is just to get the property back at the end of the day. Others are interested in making a rate of return and looking to be repaid."

He notes that the rates charged to borrowers will not necessarily differ between the two main types of lenders, but loan-to-own firms may be less flexible.

Alternatively, one might divide the world of hard money into firms with formal funds - typically involving high-net-worth individuals and institutional investors - and companies that raise money on a deal-by-deal basis. Palisades Financial operates with discretionary capital raised from its investors.

While soliciting capital via a mass mailing containing the rate and details of a given property might seem inherently more risky than the formal-fund model, Bergstein points out that established commitments may not always be the guarantee they once were.

"Institutional money - in some cases - has pulled away, because they have their own problems," he says. "A lot of the hedge funds had set up real estate shops and now may not be able to commit what they thought they were going to commit." One fund recently saw $75 million in committed institutional money suddenly withdrawn - a situation that Bergstein does not believe will occur often but may continue to pop up in isolated cases.

3. As the federal government continues to try to unfreeze the credit markets and aid the U.S. economy, what effects might these efforts have on hard-money finance and commercial real estate lending in general?

"Even though the Fed keeps dropping rates to pump liquidity into the system, lenders are not reducing rates for real estate," notes Bergstein. "They're increasing them back to what the appropriate risk level is."

During the past few years, the excess of available money for mortgage finance led to misguided pricing, he recalls. In one instance, the A tranche in one securities package sold at LIBOR +600, while the C tranche - despite its sharp movement up the capital stack and associated increase in risk - sold at only LIBOR +875.

"That's not appropriately pricing risk, and I think that is the most important thing" Bergstein says. "Risk is being repriced again, and it's going to hurt."

Like most forecasters, he also believes commercial property prices will drop substantially over the next year. That drop in value goes hand in hand with an increase in cap rates, and relief on either front may not occur for a while. The majority of commercial mortgages from potentially troublesome commercial mortgage-backed securities pools have not yet reached refinance and, perhaps more importantly, a consumer-based recession seems firmly in place.

As economic events in the past couple of months made frighteningly clear, "The consumers are broke, their pensions have been decimated and there is little credit available for them to make purchases," notes Bergstein, adding that the ripple effect has proven to be enormous.

Consequently, traditional lenders may be stalled for a while. Outside of private capital, "Money is not cheap, nor is it plentiful," Bergstein remarks.

- Jessica Lillian

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