



## Build to Rent Funding: Setting Priorities and Vetting Lenders

The very first thing you need to do is decide on what's important to you when negotiating with a lender. Is it leverage and borrowing the maximum amount possible? Is it the interest rate? Is it how much time you're given for construction and/or on a permanent basis before your rate resets or balloons? For the purposes of this handout, we're going to assume that you're building to rent. If you're not building to rent (for example building spec homes) then you can ignore the parts of this that deal with the permanent debt.

### In any Build-to-Rent scenario you will have 3 components to your lending needs:

1. Land Acquisition
2. Construction Funding
3. Permanent Funding

**[1] Land Acquisition:** you may own the land in cash in which case you can go straight to seeking construction funding. Or you may need to first borrow money to acquire the land. If you need to borrow money to acquire the land, there will be 2 scenarios here:

- A. You need to first acquire land, then plan your project, in which case you'll need a land-only loan
  - There are banks that will finance land but not every bank will. Any properties which are not producing income are generally trickier to fund and the loans that you will be able to obtain typically won't go above 60-65% LTV at best
  - Consider going the private money route if you need to fund land and are looking for leverage
- B. You need to acquire land and are ready for construction, in which case you'll need an acquisition + construction loan

**[2/3] Construction Funding / Permanent Funding:** If you're building to rent, you need to treat construction and permanent funding as a package and try to always line up both at the same time. Reasons:

- Any construction lender who knows what they're doing will underwrite your deal based on how much **permanent** debt your build to rent project will support, based on a specific permanent rate, amortization and a minimum DCR. That means they'll cap their construction loan (likely) at that "max perm loan" amount.
  - This may be true even if your construction lender will not be providing the perm loan. If they have to take over the project, they don't want to be owed more money than the income from the property can pay back.
- **You should aim to have your permanent debt (and rate) locked in when you start construction.** Reasons:
  - **You avoid refi risk.** What you don't want to do is scramble to refinance when you're in the middle or at the end of your construction. Lending environment may change mid-project to your detriment.
  - **You avoid rate risk.** You underwrite your build to rent projects at a certain interest rate and to a certain DCR. If the rate environment changes (rates go up), you will have to refinance at a higher rate than in your pro-forma. At tight initial debt coverage ratios, this will mean not only lower

cashflow but likely that you'll have to bring cash to the table to refinance. Both are negative outcomes that can easily be avoided.

- **You can avoid refi costs.** Many lenders offer combo loans that will automatically roll over your construction into a permanent loan (often called "mini-perm). Roll over happens when construction loan is fully drawn and your deal reaches "stabilization". In these loan structures, there is no actual refi that takes place and no costs are typically attached to the roll over.

## Let's Tie it All Together

If you're doing Build to Rent, you want to:

1. **Maximize Leverage.** This means you want a permanent loan that will:
  - a. Target the lowest Debt Coverage Ratio possible (for example 1.20 will give you more proceeds than a more conservative 1.30)
  - b. Give you the longest amortization possible. Loan underwritten to a 30-year amortization will give you more loan proceeds (or more cashflow) than a loan underwritten to a 25-year amortization.
    - i. When you increase amortization, you can either increase leverage to hit the same target DCR or keep leverage the same while getting higher cashflow
2. **Limit Risk.** This means you want a perm loan that will:
  - a. Allow a rate lock when you close on construction loan (at the latest)
  - b. Give you as long of a permanent term as possible before rate resets or the loan balloons
3. **Maximize Upside.** This means you want a perm loan:
  - a. With as little prepayment penalties as possible. This way you have a satisfactory perm rate locked in but can also get out of it if the rates drop while you're under construction or sometime during your fixed (amortizing period).
    - i. A typical prepay penalty is 1% of outstanding principal balance if you refinance the loan early with another lending institution
    - ii. A prepay penalty ideally will not apply if you refinance the loan with the same lender or if you pay the loan down yourself or sell the property
    - iii. Some lenders like to impose harsher prepay penalties (example: 5,4,3,2,1 step down) which will make it much more expensive to refinance should the rates go down

The idea is to only put shovels in the ground when you have predictability of cashflows but also leave yourself upside if the rate environment changes in your favor.

## Questions to Ask Potential Lenders

Any conversation should begin informally. If this is your first time speaking with someone, you need to establish a basis for a relationship before you jump into the nitty gritty.

- So, start by telling the lender a bit about yourself, your company, your business and your goals.
- Talk about your team if you have put together a good one already.
- Then ask the lender to tell you a bit about their company.
- How long have they been around?
- What kind of loans do they specialize in?
- What markets do they serve?
- What kind of projects are they looking to lend on the most currently?

You don't want to try to fit a square peg into a round hole, so assuming the lender funds ground up construction projects and wants to fund your type of deal, you can start to get into specifics:

- Do you offer construction as well as permanent financing?
  - Loans that roll over into perm?
  - Can I lock in the perm rate at the Commitment Letter Stage?
    - If not, then at construction loan closing?
  - What is a typical term for a perm loan? (5, 7, 10 years, longer?)
    - Does the interest rate then reset or does the loan balloon?
  - What kind of prepay penalties do you typically attach to the permanent loan?
- Will the construction rate be floating or fixed?
  - How do you set construction rates? What are they indexed to?
  - How do you set permanent rates? What are they indexed to?
- How you underwrite permanent loans?
  - What kind of DCR do you require?
  - What kind of amortization?
  - What kind of vacancy do you typically want to see in a pro-forma?
  - Will you allow mixed use on a speculative basis without pre-leasing and give credit on a pro-forma?

**These are just the starting points for your conversation but should allow you to narrow down the right lenders to pursue!**