# Credit Risk Ready Podcast

## Host Linda Keith, CPA, With Gina Marotta

## *Avoiding the Drivers of CRE Default: 10 Lessons Learned from Banks That Failed*

This is Linda Keith, CPA, with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community and regional financial institutions across the United States, their regulators, and banking advisors, to better understand and mitigate credit risk in any environment.

Our guest today is Gina Marotta, an independent consultant in commercial real estate due diligence. She currently works directly with community, regional, and national financial institutions who need a CRE collateral subject matter expert.

Her deep expertise comes from 30 years in this field and includes loan CRE underwriting and due diligence on behalf of high yield investors. Most interesting to me, during the Great Recession, Gina was on a team that revalued CRE portfolios of banks the FDIC had slated for closure. In today's episode, we'll key in on CRE underwriting at loan origination.

Thanks for being here, Gina.

**Gina Marotta:**

You're welcome, Linda. Thanks for having me.

**Linda Keith:**

If you're not driving, you might follow along in the PDF Gina has made available down in the show notes, *10 Tips to Avoid the Drivers of Default and CRE Loan Underwriting and Due Diligence*.

So, Gina, because of your deep expertise in CRE evaluation and underwriting, you were on a team that went into the banks the FDIC had chosen to close to help revalue their portfolio for the FDIC, and the bank didn't even know what the FDIC had decided. So, what were some of those bullet point do's and don'ts that really surfaced in that process?

**Gina Marotta:**

Yeah, thanks, Linda, I think that's a good way to start the conversation, because there were some real lessons learned as a result of my peeking under the hood, so to speak.

**Linda Keith:**

So, you've provided the *10 Tips to Avoid the Drivers of Default* that you discovered and, looking at those failed banks, let's just start and run through the list.

**Gina Marotta:**

I think the first one most paramount is KYC: it's not just know your customer but know your collateral. Secondly, I would highlight that an understanding that a commercial loan and a C&I loan are different. Commercial real estate investor loan versus C&I loans versus construction; underwriting and due diligence is different. It's important that the lender understand that. Third, do not rely on the appraiser to carry out your property due diligence. I saw a lot of community banks relying on the appraiser to do the due diligence. Fourth would be to understand the difference between due diligence and underwriting as it relates to each loan request. And the difference between due diligence and underwriting is underwriting is quantitative, due diligence is qualitative.

**Linda Keith:**

I did not know that. I know what due diligence is, I just never thought of it as qualitative.

**Gina Marotta:**

Yeah, qualitative just in terms of property condition; property marketability; property operations; the management; and management's background to be able to operate and lease your collateral property. A lot of appraisers go into due diligence that it's a much wider box than underwriting.

**Linda Keith:**

And underwriting is the calculations, debt coverage, rent roll calculations- those types of things?

**Gina Marotta:**

Including valuations.

**Linda Keith:**

Okay.

**Gina Marotta:**

Yup, all the metrics, all of the numbers to support the repayment of your loan.

**Linda Keith:**

Okay.

**Gina Marotta:**

Fifth, what I just saw a lot in community banks, I'd look at their narratives, their credit memos, if they were doing underwriting in a Word document. You cannot underwrite- again, we just talked about underwriting is about doing math- you can't underwrite a property and its rent roll in a Word document. You need to use Excel or some type of prepackaged program that will do the math for you. And it is important to underwrite a rent roll.

A lot of the loans that I looked at for failed community banks, they did not understand their leases. They didn't understand lease expirations. They didn't understand the capital requirements to re-lease space: that's tenant improvements and lease options. We need to see the borrowers have the cash to fund those costs in order to keep the cash flow in place to pay our loan. So, the sixth item is read the leases.

**Linda Keith:**

Oh no.

**Gina Marotta:**

Yeah, read the leases, which I know they can be big documents, so I would recommend having leases professionally abstracted. Because attorney abstracts can be expensive, I highly recommend that a professional due diligence lease abstractor over an attorney is hired to complete the work. They know exactly what to look for for loan underwriting and are less expensive than an attorney.

**Linda Keith:**

Well, I'm guessing that a lot of lenders faced with reading this long lease feel like our borrowers who are reading the loan documents. Page, upon page, upon page; you do not know what is boiler plate, what's specific to this lease. What's not important, what is important. So I can imagine that having someone extract what is relevant and critical, and then I suppose once you've had some leases abstracted that you, as the lender, start learning a bit about what's critical to learn from these leases.

**Gina Marotta:**

That's an excellent point. I think having a third-party abstractor abstract these leases allows the bank's underwriting team to build its skill set for credit analysis around leases. So, it's dual purpose, training and underwriting.

The seventh item is do not underwrite a property using tax returns. And I know that this, Linda, this is marching into your domain, but the point being tax returns are not timely. Critical detail necessary in understanding cash flow- and that's property cash flow. Not borrower, but property- cash flow is lost. Accordingly, and in lieu of tax returns, it's highly recommendable that the underwriter request a trailing 12-month profit-and-loss statement, which is called the T12, which is the last 12 months of income and expense history. Most borrowers can produce this.

I have also highly recommended to underwriters, because I see this happen and it's a huge mistake, is don't underwrite a property based on a broker package. All lenders source product through brokers; a majority of loans that are underwritten and closed for commercial real estate investment rely on a

broker package. Sizing of a loan based on a broker package and putting together a term sheet is fine, but not underwriting. The reason being is that the broker does not guarantee the loan, doesn't guarantee the carve-outs, and you want to ensure that the borrower actually understands their property and is capable of generating basic and essential financial reports for his or her own property, and that would include a rent roll and a property operating statement.

**Linda Keith:**

So, what you're saying is that the lender needs to move quickly to interacting directly with the borrower instead of interacting and getting their primary information from a broker. Is that what I'm hearing you say?

**Gina Marotta:**

Yes, they can get… So, the broker package is the broker’s marketing materials and it's to be able to sell the loan, if you will, to the lender. But when you actually get the loan under contract and in your term sheet, you should specifically request that the seller, because it puts an acquisition loan you have to rely on the seller or your borrower on a refinance, provide you with a property-management-generated rent roll, not something that the broker has put together.

**Linda Keith:**

And not the borrower directly; it needs to be an outside property management firm?

**Gina Marotta:**

No, typically borrowers are not in the property management firm. There's either a third-party management company or they have a separate company that's staffed by a team of people that handles their property accounting and property management. Really depends on the property type, Linda. Every property type has a different customary practice as it relates to management and operations.

**Linda Keith:**

And there's lots of different property types in the bucket of commercial real estate, right?

**Gina Marotta:**

That's right. And we haven't even talked about construction loans, which are a very important asset class and entirely different script for due diligence, underwriting, and portfolio monitoring.

**Linda Keith:**

So I can imagine, as a loan originator, you might have been doing CRE for quite some time, but if you get a type of loan you're not familiar with, you really need to go to school a bit to understand, “What do I need to do differently for office space, for multifamily, for strip malls?” Because there are major differences.

**Gina Marotta:**

Nuances, that's right.

**Linda Keith:**

Okay, you want to continue? We have eight of your 10. So how about nine?

**Gina Marotta:**

Yeah. Oh, this is an important one, and this was a huge driver of default, and that is real estate does not mark to market as an operating business. It can have sudden spikes in cash flow due to lease rollover. Remember, know your leases. Not only due to a loss of income, but the capital costs of leasing commissions and tenant improvements to re-lease space. Make sure the borrower has the cash reserves necessary to fund the costs to re-lease space. So from an underwriting perspective, and I saw this at community banks for collateral properties that had leases, they did not normalize an underwriting factor for tenant improvements and leasing commissions, nor replace reserves, because it's not just about collecting income and paying your operating expenses but making sure you have the reserves.

Leasing commissions have to be paid up-front when a new lease is signed for property that has vacant space. And if the borrower doesn't have leasing commissions, which could range into the six figures for larger properties, can't pay the broker, you're not going to be able to get that income replaced that was lost due to an expired lease.

**Linda Keith:**

Is it a common practice for owners to have this or is it really common that they just don't have the money set aside for improvements and lease commissions they'd need to have when a tenant needs to be replaced?

**Gina Marotta:**

It depends on the experience and sophistication of your borrower and there are those that know it's a good practice and they need to have it. There are others that are working so fast on doing deals they actually don't put it into place. They know it's a good practice, but they don't put it into place and they're just hoping that tenants renew and don't expire. The other factor that is a driver of default is borrowers not setting aside reserves to replace the roof, to replace the HVAC units, to replace parking lot repairs.

Now, there are leases that require the tenants to pay for those costs, so that's why it's very important to read the leases. Who is responsible for HVAC repair and replacement? And leases are very specific on that, and those are real costs that affect your cashflow and that affect your tenants, your tenancy in properties. If you've got a broken HVAC system, an HVAC system can run $8- to $10,000 a unit depending on the ton capacity. You've got to have that money to be able to replace them. Your tenant can withhold rent if their HVAC is not working. Again, depending on lease provision. So, that working capital fund, the releasing costs.

I had a client recently. He's trying to buy property. He's like, "Gina, how do I get value up?" And I said, "Well, there's three things that affect value: occupancy, rent, and your rollover costs. And if you don't have a good command of those, it is a risk factor and it will affect your value and it will affect your ability to perform."

**Linda Keith:**

Well, and therefore if you have a knowledgeable lender, it will impact whether the lender wants to fund the property.

**Gina Marotta:**

Correct.

**Linda Keith:**

Yup. All right, we have number 10.

**Gina Marotta:**

Yeah, so number 10. So, when underwriting the borrower, so this is your borrowing entity or your individuals, but your borrower using tax returns, make sure you understand the assets that are being reported at the time of filing. Are those that are still in place? A lot of these borrowers that are buying investor real estate, they use these borrowing entities to cycle through assets at the onset. There's a lot of 1031 exchanges that happen. With a 1031 exchange, you may be the up leg on an acquisition. Keep in mind that the borrower tax returns of the prior assets, they're selling their property, or they sold that property. So, you can't rely on those tax returns, because they don't own the asset anymore.

**Linda Keith:**

So, we're back to getting current real estate owned statements every time and always.

**Gina Marotta:**

Exactly. But with those borrower tax returns, it's important to understand who are the owners in that borrower and you can tell that by the K-1s. These are the same owners that are going to be part of your borrowing ownership structure for your current loan. Tax returns are excellent for C&I lending because you're dealing with property, mostly business operations. Those are preference for tax returns for business operations versus tax returns for asset ownership.

**Linda Keith:**

Well, and it's not that they're useless, they're just different. They're giving you different information. They're giving you better information about what they've done before, perhaps, but they really aren't giving you current information. And I've always said that in my training, Gina, when you come to tax return analysis of a commercial real estate developer with active deals, it'll help you know how that developer has done in the past, but it won't tell you a lot about the project they're working on right now.

**Gina Marotta:**

No, and very important for experience because I've seen, again, community banks or inexperienced underwriters put in their underwriting the leasing commission expense, or they're putting in their underwriting a roof replacement, those are not expenses that go into your underwriting. So, it's very important to understand recurring expenses versus capital or nonrecurring expenses to come up with underwritten NOI, which that NOI is what's critical to determine your valuation as well as your debt service coverage ratio and your debt yield, your NOI.

**Linda Keith:**

And NOI is net operating income, yes?

**Gina Marotta:**

That's right, yeah. And the net cash flow, which is the other number that we rely on. NOI is for valuation, net cash flow is the metric you use for your DSCR, debt service coverage ratio, and your debt yield. And I'm talking about your collateral, I'm not talking about global. The difference between NOI and NCF is your normalized leasing commission expense, normalized tenant improvement expense, and normalized replacement reserve, which there's rule of thumb numbers that are utilized in underwriting based on the property type and sometimes property vintage, property vintage being how old is the property.

**Linda Keith:**

Gina, there is so much more to this than meets the eye when you first look at it, and our banks and our credit unions, they need to have that bigger picture at this time because with the pandemic recession, the changes in value, the changes in use, whether a particular borrower, or a guarantor is damaged in some way by the recession, we need to be able to look more carefully at the CRE we are originating, the focus of this episode, but also the CRE in our portfolio cannot be a shallow view. It needs to be a deeper look using the steps you've shared with us today.

Now Gina's 10 tips are part of the show notes, so be sure to get this podcast and that document to everyone on your team that's involved in loan origination and review of commercial real estate.

Hey, Gina, thank you so much for sharing these details that will help us do a better job for our bank and for our borrowers.

**Gina Marotta:**

You're welcome, Linda. I hope it's helpful to your listeners.

**Linda Keith:**

Absolutely. Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers and our communities through the recession, safe and sound. Take care.

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## *About Gina Marotta*

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Ms. Marotta is a subject matter expert in mortgage finance, property ownership, and due diligence involving performing and non-performing commercial real estate loans and properties. In addition to structured finance transactions, she works with credit unions on the underwriting analysis of new loan participations and the completion of annual loan reviews, global cash flow analysis, and credit risk rating of commercial real estate loans.

Since 1995 she has held a variety of roles in pooled mortgage transactions that include the re-underwriting of some $70 billion in legacy CMBS loans under the US Treasury's PPIP program; managing the securitization process of commercial real estate loans; and loan re-underwriting and due diligence on behalf of high-yield investors purchasing commercial real estate loans and assets. Between 2009 and 2012, Ms. Marotta worked with a major private equity firm in building a distressed debt platform to invest in small balance mortgage loans of failed community banks throughout the U.S.

Ms. Marotta has held various senior consultant roles in Latin America since 2004 that include: social interest housing securitization transactions, enterprise risk assessments of social interest housing mortgage companies, distressed small balance mortgage loans, and operational assessments of regional mortgage and consumer finance companies.

In addition to her corporate and consultancy career in real estate investment transactions, she has been an investor in various commercial and multifamily properties in California and Michigan.

Ms. Marotta began her career in 1987 working in the urban mixed-use development group of the Santa Fe and South Pacific Railroad (Santa Fe Pacific Realty). She holds an MBA from the University of San Diego and an MA in international human rights from Columbia University. She is the founder of the non-profit Human Strategies for Human Rights, which she ran from 2001 through 2004, focusing on NGO capacity building, and held consultancy positions at the United Nations in 2000 and 2001. She maintains consultancy offices in Los Angeles and Detroit.

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## *About Linda Keith*

Linda Keith CPA draws on her 30+ years of experience consulting with and training lending institutions, background in public accounting, 15+ years as CFO of the family residential construction company, experience as an Examiner with the Washington State Auditor's Office, and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say, "Yes," to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a move afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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