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CNBusiness® Broadcast

NEWSLETTER FOR BUSINESS CLIENTS OF CANANDAIGUA NATIONAL BANK & TRUST

Commercial Real Estate Lending

The Rochester commercial real estate market has remained resilient in the post COVID, higher interest rate environment. While new construction and redevelopment projects have slowed since the pandemic, commercial property purchase/sell transactions remain consistent. As expected, refinance requests have declined meaningfully with the rapid rise in interest rates.

Commercial real estate (CRE) is income producing property used solely for business purposes. There are three basic types of commercial real estate projects. These include acquisition, construction, or redevelopment of a property.

- Acquisition - When a buyer purchases a property from another individual or entity.
- New construction - Construction of a building from the ground up on a previous vacant parcel of land.
- Redevelopment of a property - When a building is either owned or acquired and is renovated to simply improve it's current use (provide more amenities and charge higher rents) or change the use of the property. An example of this is occurring in larger cities where former industrial buildings are being converted into apartments.

Regardless of which type of commercial real estate project you are considering, there are several key metrics a bank is going to evaluate. They include cash flow, collateral, and the owner/sponsor.

Cash Flow: If the project is a simple acquisition, then the bank will review the historical annual cash flow of the property. Cash flow is total annual rents collected less annual expenses. For new construction or a redevelopment project the bank will also consider what the project cash flow is expected to be. Questions to consider include:

- Are the projected rents below, within, or above current market rents for similar properties?
- Are projected expenses below, within, or above expenses for similar properties?
- How long will it take to lease up the property?

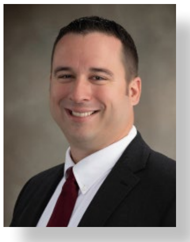
Banks want to see that the property will generate enough cash flow to cover the mortgage payments. They will calculate a Debt Service Coverage Ratio (DSCR). The DSCR formula is (net income + depreciation/amortization + interest expense) divided by (annual principal and interest debt payments). Typically banks would like to see a DSCR of at least 1.2:1.0.

Collateral: This is the actual property that will secure the loan. The bank will file a mortgage on the property to collateralize the loan and the maximum loan to value that a bank will lend to is 80%. This means that if the property is worth $100 the maximum a bank will lend is $80. Banks will hire an independent appraiser to complete an appraisal to determine the property value. For a construction or redevelopment loan, in addition to valuing the property on an 'As-Is' basis, the appraiser will also provide an expected value once the project is completed (this is called the 'As-Complete' value).

Owner/Sponsor: Banks expect the owners (also known as the sponsors) to personally guaranty this type of loan. A personal guaranty is essentially the owner signing a document that states if the property is unable to repay the loan, they (the owner) will repay the loan. Because of this, the bank will analyze the owner's financial information and evaluate other sources of income including wages from their job, income from any businesses they own, investment income such as dividends or interest, and income from other real estate projects. Additionally, the bank look for other sources of liquidity including savings accounts, mutual funds, bonds, and other marketable securities. These other sources of income and liquidity are important in case the project the bank is financing ever faces an unexpected challenge such as a mechanical system failure (furnace/boiler, roof, or other system needs to be replaced, etc.) or unexpected vacancies. Having those other funds can pay for that replacement/repair or help support the mortgage payments during an unexpected vacancy.

As a community, we are fortunate that the commercial real estate market in our area continues to remain healthy with properties holding their values. When considering a commercial real estate investment, it is extremely important to consult with your commercial banker early in the process so they can provide advice and feedback throughout the process.

To learn more about a Commercial Real Estate loan, contact your lender today at (585) 419-0670.



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Interest Rate Risk Management - Swap Loans

Interest rate swaps are financial agreements between two parties to exchange interest rate cash flows over a set period of time. The two parties agree to exchange interest rates, typically one with a fixed interest rate. This is a way for a bank to offer a long-term fixed rate in any interest environment while maintaining a competitive edge with larger banks. Interest rate swap loans allow the borrower to pay a variable rate on the loan, often using The Wall Street Journal prime rate. Under the swap agreement, a borrower receives the same rate that is paid to the bank and pays a fixed interest rate per the terms of the swap agreement.

If the rate on the replacement swap is higher when the borrower prepays, the borrower will receive a payment from the bank. Equally, if the replacement rate is lower when the customer prepays, the customer will make a payment to the bank. If a swap is held to maturity, then no “breakage” is owed by either party.

There are some situations where an interest rate swap can be valuable. When financing construction and development projects, the bank will commit to provide a permanent mortgage. This is typically offered after a 12- or 24- month interest only period during the construction phase. Using an interest rate swap will allow the borrower to fix the interest rate for the permanent mortgage up to 12- or 24-months in advance. This can be extremely valuable in an increasing rate environment but, more importantly, this effectively removes the interest rate risk from the permanent mortgage.

However, interest rate swaps are not appropriate for all situations. If the borrower expects to accelerate the repayment of the loan or if the borrower anticipates selling the property in the near term, they might want to consider alternative pricing strategies. The best way to determine if an interest rate swap is a good solution for you is to speak with your lender. Your lender will be able to determine if you qualify as a swap contract participant and will determine the best structure for your loan.

According to the CME Fed Watch Tool, there is a 40% probability of a late cut in May and 60% probability that interest rates will remain flat at their current range. These numbers are significantly different from the January predictions. This demonstrates the volatility of interest rate markets and the benefit that interest rate swap can provide.

CNB partners with B&F Capital Markets to provide our borrowers with an interest rate swap. This partnership with B&F allows us to initiate, develop, and grow successful interest rate product programs for the benefit of our commercial loan clients. However, it is imperative that the borrower has a full understanding of the loan and that all their questions or concerns are addressed before proceeding.

If you are interested in learning more about interest rate swap loans, contact us today at (585) 419-0670.

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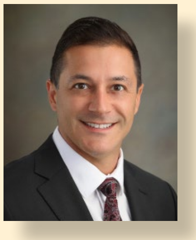

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