SBL Refinance Analysis

A cash out refinance should include any transaction where the proceeds of the new loan exceed the balance of the existing first mortgage loan, plus junior capital such as a second mortgage, mezzanine debt or preferred equity, and reasonable closing costs (inclusive of prepayment penalties). If the sponsor is not including all the collateral from the existing loan in the new loan, the release of the collateral should be viewed as a cash out from the refinance.

The cash out percentage is calculated as any cash out proceeds divided by the balance of the existing first mortgage loan plus junior capital and reasonable closing costs (inclusive of prepayment penalties).

A cash out transaction after a short-term hold period is subject to additional underwriting measures to ensure that the increased underwritten NOI and value are sustainable and well supported.

Increases in NOI and value can occur as a result of a new owner simply recognizing that the property's rents are below market and raising rents to the higher market levels. Increases in value and NOI can also result from the completion of a value-add investment strategy by the sponsor. Elements of a value-add strategy can include:

- Interior renovations (flooring, cabinetry, bathroom fixtures, appliances, new HVAC)
- Exterior renovations or improvements (adding amenities, lighting, fencing, landscaping)
- Curing deferred maintenance (replacing roofs, repaving parking surfaces, exterior painting, repairing siding)

The increase in value should be measured by the difference between the current Net Rental Income (NRI) and the NRI prior to the improvements. For underwriting purposes, the increase in value is measured by the increase in Net Rental Income, not Net Operating Income, to avoid the risk of a sponsor aggressively cutting expenses to an unsustainable level.

\[
\frac{NRI_1 - NRI_0}{CapRate_1} = Value\ Increase\ from\ Change\ in\ NRI
\]

The underwritten value for the new transaction should not materially exceed the sum of the sponsor’s acquisition cost basis, plus the value increase from the change in NRI. The sponsor’s acquisition cost basis should generally exclude the cost of discretionary capital improvements completed after acquisition, however in certain situations, costs incurred to cure deferred maintenance present at the time of acquisition may be appropriate to include in the cost basis.

Underwriting guidance:

1. In the case of a property benefiting from capital improvements, the sponsor should provide a reasonably detailed summary of the improvements that were completed, including a description of the nature of the improvements and an outline of the costs and categories of improvements. This information should be fully available prior to the inspection such that it can be verified on-site.
2. Value must be supported by change in NRI (ideally the sponsor will provide a rent roll dated prior to the improvements to compare to the current rent roll).
3. No credit for increased Other Income.
4. RUBS income must be based on T12.
5. T12 collections must be provided, with no deterioration in T3.
6. Taxes underwritten to greater of 80% of underwritten value and the appraiser’s estimate of taxes.
7. Underwritten expenses not less than T12, in the aggregate and by expense category.
8. Sponsor must provide support for acquisition price or cost basis (e.g. existing Freddie Mac loan files, settlement statement from original purchase, title policy, tax return schedules, recording information, other public information)