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STORMFIELD INSIGHTS

Bridge Loans

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In our last Stormfield Insights paper we discussed residential transition loans ("RTLs") and its two primary sub-strategies: single family "fix-and-flip" lending and value-add multifamily lending; the common denominators being the focus on residential assets and an element of renovation undertaken by the sponsor. In this paper, we will turn our attention to our other primary lending strategy – bridge loans.

Bridge loans share many similarities with RTLs, both are non-bank private mortgages and both feature similarly short terms (rarely more than 24 months), interest rates, fees and covenants. However, two key differences separate a bridge loan from its RTL counterparts. The first is the absence of a construction component – a bridge loan is secured by a property in its "as-is" condition and does not envisage any refurbishment. The second is the nature of the transaction. RTLs follow a very specific path: purchase, renovate, sell. In contrast, bridge loans are used in a wider variety of situations and have a correspondingly wider range of resolution outcomes. In the sections that follow, we will cover some of the most common bridge loan scenarios.

Time of the Essence ("TOE")

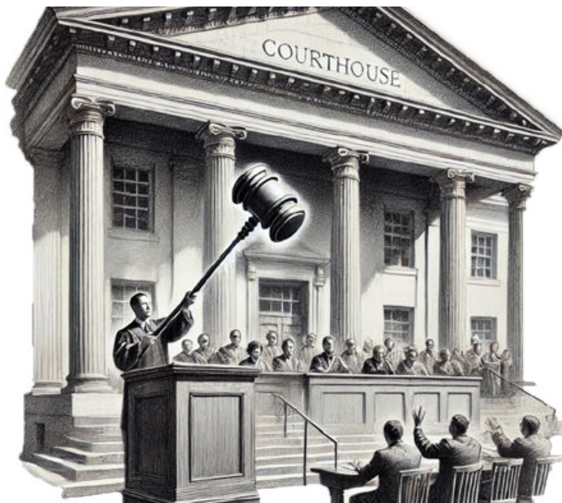
As the name implies, a time of the essence ("TOE") transaction is the product of a time crunch, where a borrower needs to close in as little as two weeks – a timeframe far too short for a conventional bank lender to meet. TOE transactions tend to cluster in three sub-types, a bank fallout, a 1031 tax exchange or an auction/quick close situation.

In a bank fallout, a sponsor has identified a target investment property and has an earnest money deposit at risk. The sponsor will generally have been working with their relationship bank to obtain an acquisition loan when something unexpected causes the bank to have to delay or cancel the planned financing. This can range from the bank being acquired, to a loan officer leaving or the banking industry in general hitting a period of turmoil as was seen in 2008, or more recently in early 2021. Regardless of the cause of the fallout, a sponsor will often turn to the bridge market to preserve their investment opportunity and to avoid the loss of their earnest money deposit.

Relatedly, many real estate investors can find themselves in a time crunch when pursing a 1031 exchange. A 1031 exchange refers to the section of the U.S. tax code that allows a real estate investor to roll the proceeds of a real estate sale into a new real estate investment without incurring capital gains tax. While very attractive from a tax perspective, 1031 exchanges are subject to very strict benchmarks and timeframes set by the IRS. Significantly, 1031 exchanges must be completed within 180 days of the sale of the first property. In cases where a transaction falls through on a target property with less than 60 days remaining on the 180-day window, a sponsor will often turn to the bridge market to finance the acquisition of a substitute property given the inability of most banks to close on an acquisition loan in less than eight weeks.

Lastly, TOE loans will often arise in a scenario where an investor is pursing an opportunistic investment via an auction or short sale. In situations such as these, an investor is usually required to bring a 10% deposit to the auction and be able to fully close in 30 days – a timeframe

far too short for conventional lenders. Investors in these transactions will generally turn to the bridge market to acquire the subject property.

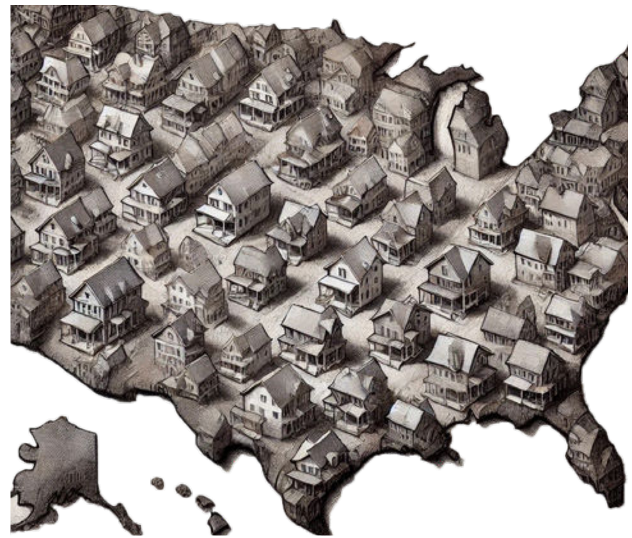


Recapitalization

A bridge loan can also serve as an effective means of recapitalization. For buy-and-hold real estate investors, the equation for building equity is a straightforward process: as the property amortizes and (ideally) appreciates in value over time, their equity grows accordingly. Over time, the next logical step for a savvy investor is to find another lucrative investment opportunity. One of the quickest ways to access the equity locked in a property is by using a bridge loan. The funds obtained can then be reinvested into another property or project. This approach facilitates portfolio expansion and also enables investors to act swiftly in a fast-moving market.

Another common situation is a partner buyout. In such a scenario, a property may be owned by a group of partners, each of whom has personally guaranteed the existing debt on the property. In the event that one partner wishes to leave the partnership and sell their equity stake to the remaining partners, it may be more expedient for the remaining partners to use a bridge loan to refinance the existing debt, thereby removing the exiting partner's personal guarantee from the capital stack. Once the exiting partner has been removed from investment, the remaining partners can then refinance the bridge debt with traditional financing. Bridge loans can also be used to simplify a capital structure that includes expensive subordinate debt and/or tax liens. This often occurs alongside the borrower undertaking steps to improve their personal credit score. Once these steps have been taken, a borrower will often be able to reenter traditional capital markets to obtain permanent financing in order to refinance the bridge debt on the property.

Lastly, multi-state "blanket loans" where a sponsor uses multiple properties in disparate jurisdictions as collateral are another use case for bridge loans – particularly in situations where time is a critical factor. Many traditional banks often face geographical limitations which exclude them from offering geographically diverse blanket loans, extending the timeframe required for a sponsor to find a traditional financing solution. A bridge loan can buy the sponsor time to find a bank with operations overlapping with the location of the collateral properties.



Reorganization

A kinder term for "distress." In certain situations, a sponsor experiencing financial distress, either due to foreclosure and/or tax liens, can use a bridge loan to negotiate with creditors and stabilize an otherwise appealing asset. After an appropriate "seasoning" period with consistent payment performance, the borrower will often be able to reenter capital markets to obtain transitional or permanent financing. Should a refinance not be possible, the removal of liens and litigation enables the sponsor to conduct an orderly sale, free of encumbrances, thus maximizing the sale proceeds from the asset.

Conclusion

Bridge loans can be used in a wide range of situations – ranging from "problem solving" to the facilitation of opportunistic investments. Though some bridge loan categories share commonalties (such as a time constraint), each situation type requires specific expertise to evaluate. Additionally, not all bridge loan scenarios are equally appealing at the same point in the economic cycle. Underwriting such loans with an informed and sober assessment of the business plan, capital market options, and exit scenarios is of the utmost importance.

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1. Banks utilize double entry bookkeeping whereby a new loan creates two corresponding entries on its balance sheet. The first is the creation of the loan as an asset on the balance sheet, the second is a corresponding newly created deposit, which is entered as an offsetting liability on the balance sheet. Hence, the creation of a loan actually creates deposits.
2. Source: Trepp