APPENDIX C

UNDERWRITING CONSIDERATIONS BY PROPERTY TYPE

EXAMINERS SHOULD UNDERSTAND THE unique characteristics and risks associated with various types of properties, and banks should establish prudent policies that consider these characteristics and risks for each loan type they finance. General considerations for the primary property types are discussed in this section. Underwriting metrics are provided only for general guidance and vary by market, property type, and building characteristics. Appraisals of similar properties and third-party surveys can provide information that is more specific to a property's characteristics and market.

OFFICE

Office buildings can be classified as suburban or central business district (CBD) properties and graded in terms of quality from A to C. Class A properties are newer, recently rehabilitated, or very well-maintained properties built of high-quality materials offering retail and other amenities. Class B properties are older or of average construction with few or no amenities and average desirability, while Class C offers space that may be outdated or plain but functional.

Important characteristics to consider when evaluating an office property are the aesthetics of the design and quality of materials, availability of parking, access to public transportation or major roads, and proximity to hotels, shopping, and other amenities. Also important are the size and configurability of the floors (the floor plate) to accommodate tenants requiring various amounts of space, adequacy of elevator service, and the ability to meet current and future technology requirements.

Medical office buildings have unique requirements, including additional plumbing and wiring to accommodate examination room fixtures and equipment. Consequently, costs for construction and tenant improvements are higher than conventional office buildings. These buildings are often located near other medical service providers, such as hospitals, and may feature pharmacies and lab facilities.

Office buildings are usually leased on a gross basis (expenses paid by the landlord) with the tenant typically responsible for expenses directly related to occupancy such as utilities and janitorial. Because terms can vary from lease to lease, however, lease agreements should always be reviewed to determine which expenses are the landlord's responsibility. Lease terms are typically for periods of three, five, or seven years.

Replacement reserves for office properties are underwritten on an annual, per-square-foot basis and vary depending on the property's age and condition. Management fees are typically underwritten from 3 to 5 percent of effective gross income, depending on the number of tenants.

Costs to re-lease space are important underwriting considerations. These costs include leasing commissions and the cost of tenant improvements for new and renewing tenants. Leasing commissions are calculated as a percentage of total lease payments with typical underwriting assumptions of 4 percent for new leases and 2 percent for renewals. Expenses for tenant improvements are higher for new tenants than for renewing tenants and can vary widely depending on the market and building class. The re-leasing costs can be projected by an analysis of the rent roll and utilizing an assumption about the probability of renewals with 60 to 65 percent being typical. Re-leasing costs are not always considered as an operating expense in calculating NOI but are an important consideration when analyzing cash flow.

Source: The Office of the Comptroller of the Currency (OCC) Comptroller's Handbook, "Commercial Real Estate Lending," August 2013, http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/cre.pdf.

RETAIL

There are many types of retail properties. They may be anchored, with major tenants that generate traffic for other tenants and provide financial stability, or unanchored. They range in size from very small neighborhood centers serving their immediate communities to super regional malls that may have 1 million square feet or more drawing from very large trade areas.

Demographics, including population concentration and income levels, along with vehicular traffic volume, site configuration, ease of ingress and egress, parking, surrounding residential density, and tenant mix are all important in determining the success of retail properties.

Appropriate site characteristics are critical to the success of retail properties. Some things to consider include the following:

- The traffic count should be suitable for the retail type; small neighborhood centers can be successful on tertiary or secondary roads while larger properties, such as power centers or major malls, require location on or access to primary arteries.
- Properties and signage should be readily visible to passing traffic; sites that are parallel to the primary source of traffic flow are generally superior to sites that are perpendicular to the road, having less frontage and visibility.
- Traffic control devices and turning lanes should permit easy access for vehicles passing in either direction at all times of the day.
- Lease terms generally vary by retail type and tenant. Considerations include the following.
- Lease terms typically range from five to 10 years with anchor tenants often signing leases of 20 to 25 years with options to renew.
- Leases are commonly written on a net basis with tenants reimbursing the landlord for common area maintenance (CAM), including landscaping, refuse collection, taxes, in-

surance, and lighting of parking lots and walkways, with the landlord usually responsible for the roof and outer walls. Because terms can vary from lease to lease, however, lease agreements should always be reviewed to determine which expenses are the landlord's responsibility.

- Anchor tenants may pay a flat rate plus a percentage of their annual sales (percentage rent). Percentage rents may vary considerably and are inherently less predictable. The flat rate should be high enough to dissuade the tenant from ceasing operations while maintaining possession in order to prevent the landlord from leasing to a competitor. It is desirable for an anchor tenant's lease to require continued operations so that the tenant may be replaced if it ceases to operate.
- Some lease clauses may call for a decrease in rents or permit termination if an anchor tenant ceases operations (co-tenancy clauses). These clauses make the success of anchor tenants even more critical to the viability of the property.

Tenant improvements provided for retail tenants tend to be minimal, with the landlord usually delivering a so-called white box (primed drywall and a concrete floor) to the tenant who is responsible for finishing the space.

Replacement reserves for retail properties are underwritten on an annual per-square-foot basis and vary depending on the property's age and condition. Management fees are typically underwritten at 3 to 5 percent of effective gross income, exclusive of reimbursements.

Re-leasing costs consist mostly of leasing commissions, which are usually underwritten at 4 percent of the total lease payments for new tenants and 2 percent for renewing tenants as determined by the underwriting assumptions with respect to tenant renewal.

INDUSTRIAL

Industrial properties include manufacturing, light industrial, warehouse, and distribution facilities. While industrial properties can be located in older or redeveloped urban areas or in the suburbs, their proximity to transportation is an important factor. This is also true of distribution facilities where access to major highways is of crucial importance.

Industrial buildings can vary widely in size, typically ranging from several thousand to several hundred thousand square feet and may be single tenant or multitenant. Office space usually comprises about 10 to 20 percent of the total square footage of these properties.

Physical characteristics that can accommodate the operations of prospective tenants are critical considerations. Industrial properties usually feature ceiling heights that range from 18 to 30 feet and require sufficient truck bays with a site large enough to permit the maneuvering of large trucks. Electrical capacity and floor thickness are important considerations. Properties that do not meet these criteria may be at a significant disadvantage relative to competing properties.

Industrial properties having a higher percentage of office space, sometimes 50 percent or more, are commonly referred to as flex, research and development, or high-tech. The industrial portions of these buildings tend to have office-like ceiling heights with few or no truck bays. These properties share many characteristics with office properties, and these characteristics should be considered when the properties are underwritten.

Industrial properties as a group pose the highest risk of environmental contamination and merit close review of past and intended uses and investigation of their current environmental condition.

Manufacturing facilities are often built to accommodate a specific user's needs. The adaptability of the building to meet the needs of other potential users is an important underwriting consideration.

Leases for single-tenant industrial properties are usually written on a net basis with the landlord responsible for maintenance of the roof and outer walls only. Because terms can vary from lease to lease, however, lease agreements should always be reviewed to determine which expenses are the landlord's responsibility.

Landlords for multitenant properties would typically be responsible for CAM and require reimbursement for this from the tenant.

Lease terms of three to five years are common. Replacement reserves for industrial properties are underwritten on an annual per-square-foot basis and vary depending on the age and condition of the property. Management fees typically range from 3 to 4 percent, depending on the number of tenants.

MULTIFAMILY

Multifamily rental properties fill an important need in many communities; they can be more affordable than owner-occupied housing and offer relatively short-term housing solutions. Multifamily, or apartment, properties have historically been one of the most stable property types, despite typical leases of one year and higher rates of tenant turnover than other property types.

Management ability is critical to the success of these properties; inept or inexperienced management is a major cause of difficulty for loans financing multifamily dwellings. Mitigating tenant turnover requires a constant marketing effort and management must retain tenants when possible by being attentive to their needs. In addition to attracting and retaining tenants, management must do an effective job of collecting rents. Even though a review of the rent roll might indicate a high rate of occupancy, actual collections should be examined to determine the true economic occupancy and evaluate the competency of management and the effectiveness of its collection efforts. Whether properties are self-managed or managed by a third party, the manager's ability and experience should be carefully evaluated.

Important general considerations for multifamily properties include:

- **Demographics:** Income levels, age distribution, rate of household formations, and household sizes.
- **Economic Factors:** Affordability of entry-level single-family housing versus renting, strength of local economy, local employment conditions including current levels and trends, trends in the value of single-family housing, current levels and trends for local rents, and vacancy.

- **Location Factors**: Local quality of life; proximity to shopping, recreation, and employment; school system; and availability of land for future residential development.
- **Local and State Laws**: Rent control and/or stabilization programs, co-op/condominium conversion rules, low income housing programs.

Property-specific considerations include:

- Occupancy history
- Collection losses
- Rents as compared with competitive properties
- Management quality
- Ingress and egress
- Quality of construction, age, and condition of improvements
- Parking availability and convenience
- Amenities as compared with competitive properties
- Availability of individual unit metering for utilities

Lack of proper maintenance can pose a significant risk to the viability of multifamily properties. Undercapitalized borrowers may neglect needed maintenance when cash flows are inadequate which can result in increased turnover and vacancies. Deferred maintenance can significantly affect loan losses and expenses in the event of foreclosure. An inspection of the property should determine how many of the vacant units are rentable in their current condition; cash-strapped borrowers sometimes "cannibalize" vacant units of appliances, heating units, and other items when replacements are needed. It is important that banks monitor property maintenance and improvements to ensure they are timely and appropriate. Banks should ensure that cash flow is adequate to provide for necessary replacements and upgrades over time.

Historical operating expenses should be carefully analyzed. Operating expenses would usually be expected to range from 35 to 45 percent of revenue. Older properties, those with more amenities, and properties where the landlord provides heat, water, or electricity as part of the rent (usually because of lack of separate metering) represent the upper end of the range.

A multifamily property is typically underwritten with management fees of 5 percent of revenues. Replacement reserves for multifamily properties are underwritten on an annual per-unit basis and vary based on the age and condition of the property.

HOSPITALITY

The hospitality industry is highly sensitive to trends in leisure and business spending. Hospitality properties have historically experienced considerable volatility in income and value. Hotel operations can be complex and may have a sizable non-real estate component. Successful hotel lending requires specialized knowledge and should not be undertaken without an adequate understanding of the hospitality business.

Hotels may be full or limited service. Full service hotels offer a number of amenities including dining and room service, convenience retail, higher service-staff levels, banquet and convention facilities, recreational facilities, and business support services. Consequently, full service hotels derive a significant portion of their income from non-room-related activities. Non-room revenue and expense centers include banquet, food and beverage, and others.

Limited service hotels and motels offer no or limited food service and limited meeting space. Location in close proximity to restaurants is an important consideration for limited service hotels.

A hotel's franchise, or "flag," can be an important factor in the success of a hotel. Flagged hotels benefit from a central reservation service and guest loyalty programs. Other franchise benefits include brand identity, operating guidance, strategic support, uniform standards, training, and marketing and sales support.

In addition to economic conditions, the following property-specific factors should be considered:

- Current and historical profitability and trends
- Management quality
- Reputation of the franchisor
- Franchise agreement including duration and termination rights
- Property age, condition, and amenities
- Age, condition, and quality of furniture, fixtures, and equipment (FF&E) and replacement needs
- Revenue seasonality
- Proximity to transportation and demand generators such as office and recreational facilities
- Adequacy and convenience of parking

Common performance metrics for hotels are occupancy and average daily rate (ADR) and revenue per available room (RevPAR). The ADR is calculated by dividing the room revenue by the number of rooms occupied for a given period. This calculation should exclude complimentary rooms or other occupancy that do not generate revenue. RevPAR is calculated by multiplying a hotel's ADR by its occupancy rate.

Other income and expenses, such as for food and beverage, banquet, telephone, or Internet use, are segregated into separate departments. Expenses that are not directly attributable to a department, such as management, franchise, sales and marketing fees, and repairs and maintenance, are recorded as unallocated expenses. Real estate taxes and insurance are allocated to fixed expenses.

Studies of industry performance metrics provide an important comparative reference in underwriting hotels. These studies are commercially available and should be utilized in the bank's underwriting process. While an analysis of historical income and expenses should include a comparison with industry benchmarks to test for reasonableness, the following underwriting considerations provide guidance in analyzing a hotel's income and expenses:

- **Franchise Fees:** Usually underwritten at the higher of actual or 4 to 6 percent of total revenues.

- **Management Fees**: Typically expected to be 4 to 5 percent of gross revenues.
- **Fixed Expenses**: Expenses for property taxes, real and personal, should reflect the actual property tax assessment. Insurance should reflect the actual expense and include premiums for insuring the real and personal property.
- **Replacement Reserves**: Reserves for FF&E typically range from 4 to 6 percent of total revenues.
- **Profit Margins**: Vary according to type, franchise, and location. Margins for full service properties typically range from 20 to 30 percent while limited service properties generally range from 30 to 40 percent. Luxury resorts typically range from 20 to 25 percent with extended-stay suites usually ranging from 35 to 42 percent.

Appraisals of hotel properties, in addition to the market value of the real estate, may also include values of personal property, such as FF&E, and intangibles, such as goodwill. The sum of these values is sometimes referred to as the "going-concern value." The value, however, of non-real property, such as personal property and intangibles, cannot be used to support federally related transactions; value opinions, such as "going-concern value," "value in use," or a special value to a specific property user may not be used as market value for federally related transactions. An appraisal report that elicits a value of the enterprise, such as "going-concern value," must allocate that value among the components of the total value. Traditionally, the three components are described as: (1) market value of the real estate, (2) personal property value, and (3) value of intangibles. The bank may rely only on the real estate's market value in these appraisals to support the federally related transaction. A separate loan may be used to finance the personal property or intangibles. For further information, see OCC Bulletin 2010–42, "Sound Practices for Appraisals and Evaluations: Interagency Appraisal and Evaluation Guidelines."

RESIDENTIAL HEALTH CARE

Residential health care facilities typically include independent living, assisted living, and nursing homes. The most significant distinction among these is the level of care provided. While facilities are most often dedicated to one level of care, some may provide a continuum of services.

Independent living, sometimes referred to as congregate care, provides the lowest level of care. The residents do not require daily assistance with living activities and enjoy a high degree of mobility. The facilities share many of the features and amenities of multifamily properties with such additional features as dining rooms and communal living areas. The facilities may offer meals, laundry, and housekeeping. No health care is provided. These properties are not regulated and do not qualify for government reimbursement. Income is generated mostly from unit rental.

Assisted-living facilities provide a range of services for the elderly and disabled that can include meals, laundry, housekeeping, transportation, and assistance with daily living activities, such as dressing and bathing. Assisted-living facilities may be subject to state regulation with varying levels of health care permitted. When more acute medical care is permitted and provided, government reimbursement may be available.

Nursing homes provide 24-hour non-acute medical care and provide the highest level of living assistance and medical care. Nursing homes are highly regulated and, like hospitals, are subject to state certificates of need. Government reimbursement is a common source of payment.

The demand for residential health care facilities is strongly correlated with local demographics; residents want to live in locations convenient to their families, with older populations generating greater demand. The bank should consider the quality, reputation, and experience of management. Other considerations are adequacy of staffing, staff turnover, the condition and location of the facility, and the quality of care and services.

Assisted-living facilities and nursing homes are sensitive to government reimbursement programs; state and federal policies affecting qualification criteria and reimbursement rates are important considerations in the analysis of these properties. The mix of private and government pay can be a useful measurement in determining the sensitivity of these properties to changes in government reimbursement policies.