

## **FINGERTIP CONTROL: LIBOR FLOATERS CONVERTIBLE TO A FIXED-RATE**

Like the fingertip control afforded by the steering wheel-mounted paddle shifters on the new Aston Martin V-12 Vanquish, a LIBOR-floating rate mortgage capable of quickly converting to a fixed-rate loan can help the commercial real estate owner modulate and control the awesome power of today's interest rate environment.

If you're about to refinance a shopping center, a multifamily or office property in order to trade in an 8% loan for a 6% ten year fixed-rate loan, consider this:

For a strong asset, a LIBOR-floating rate in the 4% range with no prepayment penalty may well be possible today. Let's compare today's best-case 10-year fixed rate commercial real estate loan to today's best-case LIBOR-floating rate loan:

As of this writing in early September 2002 let's assume the lower 4% range for a floater, vs. the upper 5%, to lower 6% range (depending on property type and quality) for a 10-year fixed rate. Assuming a \$10 million loan amount, annual savings of \$200,000 may well be possible right now. Of course the savings would be far greater comparing a borrower's 8% current mortgage rate vs. the LIBOR floater. Obviously some borrowers making a change today are experiencing mind-bending improvements in their cash flow.

If interest rates remain stable, or if the Fed signals yet another short-term interest rate reduction, even greater savings may be possible in future months. The most dramatic among them would be the possibility of locking in an even lower long-term fixed rate than is possible today (otherwise known as: 1) float now, 2) save a bunch of money, 3) let fixed rates drift even lower and 4) THEN lock!)

Couple this potential with a "fail-safe" mechanism that will allow the borrower to use their "finger-tip shifters" to lock their interest rate in a heartbeat, and you've got a very powerful mechanism in place. This "quick-lock" capability is, of course, crucial because given the stampede mentality on Wall Street, at any moment rates could head North in a hurry.

Like all powerful machines (the aforementioned Aston Martin V-12 very much included), this approach demands focus and attention, and is definitely not for those who, at today's current ultra-low rates, would prefer to "set it and forget it".

Depending upon the needs of the borrower and their particular situation, there may also be ancillary benefits to this approach. One is the ability to increase the loan amount based on increasing N.O.I. using an earn-out structure. (For those unfamiliar with "earn-outs", this structure allows a lender to offer \$X today based on current cash flow, with an offer of an additional \$Y later on, when certain benchmarks have been achieved by the Borrower). A typical example of an earn-out scenario would be a 250,000SF building with 200,000SF rented and 50,000SF vacant. The lender will agree to close a loan for \$X

now, and will commit to advance additional funds when a) an acceptable tenant has been found for the 50,000SF space, b) the lease has been signed, and c) the tenant has actually moved in and is paying rent.

Another benefit of the "Floating to Fixed" approach would be using anticipated surplus cash flow to pay down the mortgage with no pre-payment penalty prior to locking in your rate for the long haul. For example, if you're about to refinance property #1, but you know that the sale of property #2 (or some other influx of liquidity) is likely to occur within several months, you could refinance property #1 with a LIBOR floater, enjoy the low rate, and upon the sale of property #2, use the surplus proceeds to reduce the loan amount on property #1 without incurring any prepayment penalty. Then, at your discretion, decide when to lock the rate.

At the very least, in Fall 2002 when facing the prospect of refinancing a significant commercial real estate asset, it pays to pause for a moment to consider the various ways that you can drive this very powerful machine.