

Norris & Stevens

APARTMENT INVESTORS JOURNAL

Creating Value in Investment Real Estate®
Brokerage and Management for Apartment Investments

How Defeasance Effects Your Property's Value

Every day, property owners are making decisions regarding their property that will ultimately affect the future value of their property. Most investors are familiar with the short list of “hot” topics – tenant profiles, rent increases, rehabbing the property and implementing bill-backs. *However, one of the most important decisions that will affect your property's value in the future is the loan you place on the property today.*

When evaluating a loan, many investors will “shop” the interest rate, not realizing that the terms of the loan are much more important than the rate. *One aspect of loan terms that investors should investigate is the payoff process – what happens if you wish to sell or refinance the property and pay off the loan early.* Many lenders will use different terms to delineate the pre-payment cost. *Some loans use a very straightforward approach while others are complicated and EXPENSIVE!!*

The simplest is a pre-payment penalty, which is usually a certain percentage of the loan

balance at the time of payoff. Pre-payment penalties usually decline in percentage during the length of the loan. For example, a pre-payment penalty might be 1% of the loan balance. Other lenders use a more complicated method called “yield maintenance.” This involves complicated formulas that aren't always well defined, which can lead to conflicting interpretations. *The calculations are usually binding unless you, the borrower, can prove the formula was interpreted incorrectly.* The language usually stipulates the yield maintenance penalty is the greater of the “formula” or 1% of the loan.

One of the most expensive and complex penalties is defeasance. Unlike the other methods where the existing loan is paid off, defeasance does not pay off the loan but instead involves the substitution of collateral – usually a portfolio consisting of U.S. government securities that will be sufficient to make the remainder of the monthly loan payments. *The note remains in place for the*



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remaining term. The property is released from the lien and the securities are “pledged” to the lender that originated the loan.

The portfolio of securities is assigned to a “successor” borrower, which is responsible for making the ongoing payments.

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The “successor” borrower is unaffiliated to the original loan. The amount of defeasance is tied to the securities and is only an estimate until the day of closing.

The entire defeasance process takes about 30-45 days. *In addition to the cost of securities, you are charged a “transaction cost”. This fee is used to pay the fees for the professionals used by the defeasance company.* These professionals include attorneys, accountants, trustees, rating agencies and servicers. The original borrower is responsible for paying their own attorney fees.

I recently closed a transaction where the loan balance at the time of payoff was approximately \$3,800,000. The defeasance cost was approximately \$570,000.

Defeasance as part of a loan will decrease the value of your property. Buyers are not willing to assume defeasance loan terms and the defeasance payoff is costly, thus lowering your proceeds. If you are considering selling or refinancing your property, call Norris & Stevens, Inc to discuss how to receive the maximum value for your property.