



People's Choice Mortgage

----- Commercial Lending -----

(800) 637-7737

www.mycommercialloanadvisor.com

Commercial Loan Underwriting

Unlike residential loans, commercial loan underwriting can greatly differ case by case. There are, however, certain basic ratios with every commercial loan.

Debt Service Coverage Ratio (DSCR, DSC, DSR, DCR)—this is used to determine whether a property (or business) is able to cover the mortgage and all other expenses tied to a property. Usually lenders require that the property be cash flow positive (more income than expenses) and that there is some buffer room.

Breakeven would be a 1.0 DSCR, or in other words income equals expenses. Most loan programs require a 1.2 – 1.35 DSCR or 20% - 30% more income than expenses on the property. For owner occupied businesses where there is no rental income, the requirement is usually much higher (2.0+ DSCR) because they are gauging the strength of the business as opposed to the property itself. DSCR can vary depending on loan size, interest rate and amortization.

DSCR further explained

The most important ratio to understand when making income property loans is the debt service coverage ratio. All lenders use them in calculating their amount they are willing to lend.

It is defined as: $DSCR = \text{Net Operating Income (NOI)} / \text{Total Debt Service}$

To understand the ratio it is first necessary to understand the numerator and the denominator. Let's take a look at net operating income (NOI) first.

Net operating income is the income from a rental property left over after paying all of the operating expenses:

Gross Scheduled Rents	\$100,000
Less 5% Vacancy & Collection	\$ 5,000
Loss	
Effective Gross Income:	\$ 95,000

Less Operating Expenses	
Real Estate Taxes	
Insurance	
Repairs & Maintenance	
Utilities	
Management	
Reserves for Replacement	
Total Operating Expenses:	\$ 30,000
Net Operating Income (NOI)	\$ 65,000

Please note that lenders always insist on some sort of vacancy factor regardless of the actual vacancy rate in an area to cover collection loss. In addition lenders always insist on using a management factor of 3-6% of effective gross income, even if the property is owner-managed. Their logic is that they would have to pay for management if they took back the property. Finally, **NOTE THAT WE HAVE NOT INCLUDED LOAN PAYMENTS AS AN OPERATING EXPENSE.**

Next let's look at the denominator: Total Debt Service. This includes the principal and interest payments of all loans on the property, not just the first mortgage. **NOTE THAT WE HAVE NOT INCLUDED TAXES AND INSURANCE.** They were already accounted for above when we arrived at net operating income (NOI).

To calculate the debt service coverage ratio, simply divide the net operating income (NOI) by the mortgage payment(s). For the sake of simplicity, let us assume that there is only one mortgage on the property:

\$500,000 First Mortgage
11% Interest, 30 years amortized
Annual Payment (Debt Service) = \$57,139

Then:

DSCR = Net Operating Income (NOI) = \$65,000

Total Debt to Service = \$57,139

DSCR = 1.14 – this simply means that there is .14 – or – 14% more cash left after servicing the debt.

Note – You will notice we show management expense and reserve expenses above. Even if you don't pay those expenses, lenders will allocate industry standard percentages against the income for loan purposes.

Obviously the higher the DSCR, the more net operating income is available to service the debt. From a lender's viewpoint it should be clear that they want as high a DSCR as possible.

Most borrowers want as large a loan as possible. The larger the loan, the higher the debt service (mortgage payments). If the net operating income stays the same, and the loan size and therefore the debt service increases, then the lower the DSCR will be.

Life insurance companies are very conservative and generally require a 1.25 or 1.35 DSCR. This means that their loan-to-value ratios are low.

Banks and mortgage banks generally only require a 1.20 DSCR, and sometimes will accept a DSCR as low as 1.10.

Loan-to-Value (LTV)

This is used to determine what percentage of the property is being financed. As opposed to residential programs where 100% (or sometimes 125%) financing is available, most commercial programs max out at 60% - 75% depending on property type. SBA programs can often go as high as 90% for qualifying properties (usually owner occupied businesses), but be prepared for red tape. Also keep in mind that many properties will be more limited in loan size by DSCR more so than by LTV limits.

Net Operating Income (NOI)

This is used to determine the profitability of a property. In simple terms, NOI is calculated by subtracting expenses from the income. Usually the income is decreased by a vacancy factor that the lender feels is conservative. Depreciation and mortgage payments are not included as expenses in this calculation. But there are several theoretical expenses that may apply (such as tenant improvements, leasing commissions, etc.) NOI is also used to determine cash available for debt service by dividing NOI by the minimum DSCR. Divide by 12 for a maximum monthly payment.