



People's Choice Mortgage

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

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Understanding Commercial Lending

If you are a seasoned veteran of the commercial loan process you may not need to read this, but if you are new to the commercial lending world, it is worth your time to read this article.

Applying for a commercial loan is similar to applying for a residential mortgage on your home or small multi family property, with some very important exceptions. **These differences can make or break the deal!** Things you need to consider include:

DSCR – Debt service coverage ratio

With commercial properties it's really about the numbers! The property must have sufficient cash flow to comfortably manage the mortgage debt. Most lenders use a DSCR or DCR, debt coverage ratio, of 1.2 for multi family properties. Ratios of 1.3 are common for other types of commercial properties. If the property is owner occupied, many lenders will use a lower ratio, often 1.0.

To calculate the ratio, subtract all of the operating expenses from the rental income and divide that figure, the net operating income, or NOI, by the monthly mortgage payment for principal and interest.

$$\text{DSCR} = \text{NOI}/\text{debt service}$$

See "**Forms**" on the Home Page for an income and expense worksheet to help calculate the NOI. All lenders will adjust the rental income using a vacancy factor for the area the property is located, whether you have vacancies or not. Also they will often use 5% for management expenses, 5% for maintenance & repairs, and will use 2 – 5% for reserves. Although you may manage the property yourself, unless you are an owner occupant, the lenders will use these percentages.

If the DSCR does not meet the required ratio, there are special lenders that will use your own disposable income to assist in making the commercial loan payments.

Cap Rates

Capitalization rates or cap rates are used by both lenders and investors to determine the value of a commercial property. They often depend on the type of property and the location of that property. Cap rates are calculated as follows:

$$\text{Cap Rate} = (\text{Net Operating Income}/\text{Value of Property}) \times 100\%$$

$$\text{Cap Rate} = (\text{NOI}/V) \times 100\%$$

Example:

If the NOI is \$40,000 and the market value is \$444,000, the cap rate is 9%

$$\text{Cap rate} = (40,000/444,000) \times 100\%$$

$$\text{Cap rate} = 9\%$$

The cap rate represents the annual return that can be expected on a property before mortgage payments and income taxes are taken into account.

Alternatively, the cap rate can be determined by comparable properties that have sold in the market area by knowing the NOI and the selling price. Most commercial appraisers know the cap rate for specific areas.

Example:

If the cap rate for comparable properties is 9.5%, the potential selling price or value of a property can be determined base upon the NOI. In this example, assume the NOI is \$65,000.

$$V = (\text{NOI}/\text{Cap rate}) \times 100\%$$

$$V = (65000/9.5\%) \times 100\%$$

$$V = \$684,200$$

Most lenders use cap rates to help determine the value of a property before issuing a conditional commitment letter and ordering an appraisal.

LTV – Loan to value

Most local banks are risk adverse and look for a substantial down payment when purchasing a commercial property or limit the amount of cash out if you wish to refinance. LTV typically are 70 to 75% with these banks depending on property type. We work with National Lenders with larger loan portfolios and financing up to 90% is commonplace. With secondary financing from a seller, the combined loan to value, CLTV, can be as high as 95% on a purchase.

Credit Scores

LTV and interest rates are directly impacted by your credit score. Scores range from 400 up to 850. The higher the number, the more desirable you are in the eyes of the lender. Lower the number, the higher the risk you present; and with all lenders it's all about risk.

Lenders pull your credit from all three credit bureaus; this is called a tri merge credit report and is different from the report you can order as an individual. To get a commercial mortgage you will need at least a middle credit score of 600.

Document Types

Lenders specialize in the types of loans they will provide. Some require no documentation of your personal income and assets and make their decision primarily on the cash flow of the property and its value. This is a true no – doc loan.

Other lenders allow you to state your income and assets on the loan application and do not check with your employer or the financial institutions where you do your banking. The financing provided by this type of lender is called a stated loan.

Finally, there are other lenders, which look at both your personal financial situation and the cash flow from the property. If the property does not meet the DSCR they will take into account your own disposable income and look at your debt to income ratio, DTI. This lender is a full doc lender, and they will request your tax returns for the past two years as well as recent statements of all your liquid assets. If you are self-employed they will adjust the income shown on your tax return and add back many discretionary business deductions used to legitimately lower your taxes.

Interest Rates

Rates on commercial properties are higher than residential mortgage rates. They do not typically change as rapidly as residential rates since the loans are either kept with the lender or sold off to Wall Street investors. LTV, property type, credit score, DSCR, and document type impact the rate you will receive. Some lenders make their rates available to mortgage brokers daily, others request to review the loan application along with a tri merge credit report before they will quote on a property. Rates on full doc loans are typically less than on stated income loans since there is less risk to the lender.

Loan Terms

Commercial loans can be amortized over 10, 15 or 30 year time periods. They are typically fixed for 1, 2, 3, 5, 7, or 10 years and sometimes for 15 or 30 years.

Pre Payment Penalties

All commercial lenders attached a pre payment penalty to their loan. This is because the loans are often sold to Wall Street investors with a guaranteed return. If you pay the loan off too early you will be penalized anywhere from 3 to 5% of the outstanding loan balance plus any interest due. Penalties usually run for the fixed period of the loan. Each lender has different penalty requirements.

Commercial loans typically can be assumed if you sell the property with no pre payment penalty. Some lenders will allow you to buy off the pre payment penalty which results in a higher initial rate.

Property Types

Lenders categorize properties into 4 types or Tiers. The property Tier has an impact upon the LTV, interest rate, DSCR required, and level of risk assumed by the lender. The higher the tier rating, the riskier the loan.

Tier 1	Tier 2	Tier 3	Tier 4
Multifamily	Mixed-use, commercial	Rooming houses	Restaurants
Mixed-use, residential	Office	Light industrial >25000 SF	Unflagged hotel/motel
	Retail	Heavy Industrial	RV parks
	Warehouses	Flagged hotel/motel	Mobile home parks, >25% RV
	Light industrial <25000 SF	Auto Service	Nursing home
	Bed & Breakfast	Funeral home	Assisted living facility
	Mobile Home Park <25% RV		Day care center
	Public storage		Flea market
	Veterinary clinic		Car wash
			Parking garage
			Special purpose

Photographs

All commercial lenders will require digital pictures of the property before issuing a conditional approval letter. Front, back, both sides and a view of the street will be required from the borrower. When emailing pictures, it's best to send only 2-3 at a time due to bandwidth concerns.

Appraisals

Commercial appraisal typically cost more than residential appraisals. They are more complex, require more research, often exceed 50 pages in length, and typically range in price from \$1500 to \$5000 depending on property type and location. The lender orders the appraisal and usually sources three bids and chooses the least expensive.

Appraiser uses three methods to determine the value of a property. The replacement cost, comparable sales, and the income approach. Since commercial loans are based upon the ability of the property to support the debt, lenders place the most emphasis upon the income approach to determine value.

Environmental Surveys

All commercial properties are insured for environmental risks. Insurance companies maintain databases of properties that may have environmental issues. If the property you wish to finance is in this database you will have to either remedy the issue or demonstrate that the risk has been eliminated. Part of the loan application process is the completion of an Environmental Risk Survey. Each lender has their own unique form, so once the appropriate lender is identified, we will send you the correct form.

Reserves

Lenders want to be sure that you have extra money (reserves) in a bank, RIA, or 401k after the purchase or refinance of a property. Six months is common and is based upon the amount of the principle and interest payment of the new mortgage.

Amount of Reserves = 6 x P&I payments

The reserves are extra insurance for the Lender just in case you experience a short term cash flow problem.

Closing Costs

The costs typically vary widely depending upon value, location, lender and property type. The lenders fees and attorney fees are usually higher than the closing costs for residential mortgages. Most lenders also require you to escrow taxes and insurance with your mortgage payment.

The Loan Approval Process

Many commercial lenders are now using the familiar residential Fannie Mae Form 1003. Upon completing this form, the information will be reviewed for completeness and some clarification may be needed of vital information. This application, along with a tri merge credit report is forwarded to the National Lender for review.

The lender will then issue a conditional loan approval or reject the application within 48 hours. The conditional loan approval, CLA will state the interest rate, term of the loan and stipulate any pre payment penalties. You will be asked to review the CLA and if acceptable, the next step will be to order the appraisal.

The appraisal fee will be required along with the signed CLA and an application fee before the appraisal is ordered. Appraisals may take as long as 2 to 4 weeks depending on the property and market conditions.

During this period any additional documentation the lender requires will be collected and forwarded to their underwriters. If you are purchasing a property, a signed purchase and sales agreement along with photocopies, front and back, of any earnest money deposits and digital photographs will be required.

Once the appraisal is received and reviewed by the lender, a loan approval will be issued and a closing date determined. The entire process often takes 30 to 60 days when everything goes smoothly.

For more information on PCM's commercial real estate financing options or to set up an appointment with one of our loan specialists, request information today or call 800-637-7737.