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UNDERSTANDING COMMERCIAL MORTGAGES

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Welcome to the world of commercial mortgages. This booklet is written to the individual who is venturing out into the world of commercial investment. It is written to introduce you to some of the differences between residential loans and commercial loans and hopefully help you to be more profitable in your quest for diversifying your income through commercial properties. I will endeavor to teach you the who, what, and why of commercial loans. A big part of your success as a commercial investor is in choosing the right mortgage for the property so it just makes sense to learn about commercial mortgages. What follows is the straight scoop on commercial mortgages. Knowledge is power; my goal is to give you that knowledge-accurate knowledge. And so, let's begin.

WHO?

Who lends the money in the commercial realm? This is the first and possibly most important difference between commercial and residential. Yes, you apply to a large lender or bank or some financial institution whenever you do a residential loan. But the money is not *really* lent by that institution. It is for a few days. But ultimately they sell the loan to FNMA or FHLMC and get reimbursed the money. They just keep the servicing rights. Fannie or Freddie then bundle all those loans and pass them through to investors as mortgage backed securities. In other words, the bank is not really lending their own money. It is not that way in commercial. In the commercial realm, most loans are done by banks and it is their own money. They take the money on deposit with them and loan it out to different companies. There is no giant like FNMA waiting to reimburse them. If that loan goes into default the bank is stuck unless they can sell the property for a profit. Because of this, they are much more picky than they would be on residential loans.

But that is not all. 80% of all businesses fail within 2 years and if someone does fall into financial difficulty they will let their commercial investment go before the house that their wife and kids live in. Commercial loans are investment loans and you know full well the rules are stricter on investment loans. Because each piece of property is completely different, commercial deals are not hard and fast. No standard qualifying ratios here. The property is more important than the borrower. You can have an excellent borrower but have a bad property and no one will buy the loan. I had a loan officer call me mad as anything that his client's loan was denied by our underwriter. His message was something like this, "I have a guy with perfect credit, great income, a property worth \$450,000 and all he wants is a little cash out loan of \$300,000. You must be an idiot if you can not get this loan done."

So I pulled the loan, and much of what he said was true. The borrower's credit was perfect and his income was good-except on the property. The property itself was losing money. His borrower told him the property was worth \$450,000 but based on the cash flow, it would not appraise for more than \$150,000(more on appraisals later). No one is going to loan \$300,000 on a place only worth \$150,000!

In talking to him, it turns out he has been trying to get it approved for over a year! Commercial loans are deal-specific. Understand that the bank is loaning their own money and they will be very picky on what they will lend on. The good news is that if the deal is good, there is more than enough commercial money available-banks WANT to lend. They are just more careful when it is their own money.

WHAT?

What takes commercial deals so much longer than residential loans to close? Rare is the commercial loan that closes in less than 1 month and the rate for those quick-close deals is much higher. Small commercial loans will usually take 2 months and large commercial loans can take as much as 4-6 months or more! Many factors go into this-the appraisal, the broker themselves, the title, and especially the borrower. Let's start with an appraisal. It will rarely be ordered before the loan is approved and the borrower has committed. This could be weeks into the deal. Once ordered, an appraisal on a commercial property will often take a month and it could be longer if the property is large and has mixed use. That is because the land under the commercial property is just one part of the equation. The properties value ultimately will be determined by its' cash flow. The appraiser of a commercial property has to get the financials on the property and compare it to similar properties in the area. If my apartment complex is 80% rented and the average complex in the area is 85% rented it will effect my appraisal. How the property has been managed is important. How quickly the appraiser can get that information is important. The appraiser often must contact an owner and get information direct from them. It is not as easy as pulling up an MLS listing. Don't trust someone who says they can turn a commercial appraisal in less then a week like a residential appraisal. That person does not understand commercial.

You must be careful in choosing a broker or banker to help you. A broker often can drag the file because they do not get the information needed up front. If my apartment complex is running 30% vacant compared to most places running 25% vacant then I need to explain that and have a business plan ready that explains how I am going to change that. Most brokers will send a deal in with a residential loan application filled in, a credit report and two years tax returns and think the loan can get approved. Then when asked for the stuff that is really needed-3 years operating statements, business plan for the property, etc. they balk at getting it. The loan will never get approved just based on 2 years tax returns and a credit report. Why? Because the property is the most important factor. If you get the right documents in a timely fashion, however, then your loan will move through much quicker and actually have a chance of getting approved. Because title on commercial property often involves such things as environmental and zoning issues, it can take 30 days as well. One 10 Million dollar deal got hung up on environmental issues for 3 months! The more complete the information up front-the quicker you can close.

Finally, the other big drag on commercial closing times is the borrower-and I don't just mean dragging on getting documentation. It is important to remember time frames, if you are under contract, you have 45 days of underwriting and appraisal time from the time you stop shopping, provide everything, and commit to a lender. You **CAN'T SHOP A COMMERCIAL LOAN UNTIL THERE ARE JUST 30 DAYS LEFT!** If you do, you will end up with a high rate, quick close loan, or asking for an extension and risking losing the entire property if the seller got another offer. It is not worth losing out on a property that will yield you thousands of dollars of profits in a month over 1/8th percent in rate which may mean \$50 a month saved! Don't be penny wise and pound foolish. Understand the time frames and operate appropriately.

WHY?

WHY invest in commercial real estate then? If the loan criteria are tougher, and the deals take longer to close-why not just stick with residential investing? Because, commercial properties are much lower maintenance properly managed. You can rent them out triple net lease and have the customers make all the repairs. You are typically dealing with a large building built very well and not a house with kids. These properties are not used like a residential house-people don't live there and so the life of the property is extended. And even if you are dealing with a multi-family property where people are living, you have diversified revenue. One apartment complex may have 20 units in it and so if one renter moves out you still have 19 other rents coming in. The commercial mortgage is actually your best friend because we take into account vacancy rates when underwriting the file and make sure that the property still cash flows **EVEN** with average vacancy rates for the area. You **KNOW** your return on investment going in and the risk is mitigated. **PLUS**, you get all the normal benefits of investing in Real Estate: appreciation, but you get to depreciate the asset on your returns, steady money with minimal effort, and a hedge against inflation that is tough to beat.

Commercial real estate investing can be lucrative. If you are a business owner, buying a property and fixing your payments instead of rents that escalate yearly is a smart move. Either way, commercial real estate is a smart choice. Making the right choice on your mortgage can make all the difference between a good investment and a great investment. I hope this helps clarify commercial mortgages some, for more info or assistance, please feel free to call the representative who sent you this report.

Wishing you a prosperous year,

Brian L. Peart