Commercial classroom: How banks look at commercial real estate loan requests - by Edward Smith Jr.

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This column is offered to help educate agents new to commercial and investment brokerage and serve as a review of basics for existing practitioners.

Initially when applying for a commercial mortgage on investment property the bank requests a copy of the income and expense statement and a copy of the purchase contract.

They may want to see last year, or several years back, income and expense statements and the current one which is a projection of how the property is expected to perform this coming year. This is also known as the operating statement or proforma.

The current statement will show the income from actual tenants and project income, based on current market conditions for any space temporally unoccupied. It will also make an adjustment for the possibility of vacancy or credit losses. Adding to the statement any other income to the building not from the tenants (antenna on the roof, billboards, vending machines etc.). This gives us the gross operating income for the property.

Next the owners operating expenses will be subtracted, including a contingency for emergency repairs which then provides the anticipated net operating income (NOI) for the current year.

Banks process thousands of commercial loan applications and as the do so, they see trends which are reflected in the capitalization rates (CAP rates) they use in analysis. CAP rates reflect local geographic real estate activities and are prone to gradual change. They will determine, based on actual closed transactions, a pattern for each investment category: office, retail, industrial and multi-family. Then divide the net operating income by the price paid and determine the CAP rate for that transaction. Patterns emerge indicating what is an acceptable return for investors (CAP rate) in that particular market, at that time. Banks use these trends in determining if a new loan application will be approved.

For example, if a property had a NOI of $60,000 and sold for $750,000 would reflect an 8% CAP rate

$60,000 = 8%

$750,000

With this information the banks determine their opinion of value, for mortgage purposes, of a property by dividing the NOI by the CAP rate they are currently using for that class of properties.

Next, they will underwrite the property to determine what is called the loan-to-value ratio (LTV). Historically commercial banks have required a downpayment of 30% to 40% of the purchase price. This is done by dividing the requested loan amount by the bank’s opinion of value which equals the LTV. An acceptable LTV would be 60% to 70%.

Banks look at the worst case scenario. What if we make a loan and the borrower defaults and they have to foreclose on the property. This would allow them to quickly sell the property at less than market value to recoup their losses.

The next step in underwriting is to determine the debt service ratio (DSR) a/k/a debt coverage ratio (DCR).

There is risk involved in making CRE mortgage loans. What if the building loses some tenants, reducing their cash flow and ability to pay their monthly mortgage payments? If this persists, the bank would eventually need to foreclose on that loan and take possession of the property.

The debt service ratio creates a “buffer”. Banks will only loan out a certain percentage of the NOI, the cash flow. So, if the building loses some tenants there would still be sufficient cash flow to make the mortgage payments. Today the federal guidelines require a 25% DSR, meaning the maximum annual debt service (ADS is the total principal and interest payments for that year) percentage would be 75% of the NOI. In fact, some banks today want an even higher DSR of 30%. The DSR is calculated by dividing the NOI by the ADS.

As an example, an office building has a NOI of $60,000, the bank is currently using 8% as the CAP rate for office properties.

NOI $60,000 = $750,000

CAP .08 (8%) market value

Applying for a mortgage purchased at an 8% CAP.

30% down payment

7.5% interest rate

20 year amortization

Price $750,000

Down payment $225,000

Mortgage $525,000

Payments $4,229 mo. $50,752 annual

Debt Service Ratio

NOI $60,000 = 1.18

ADS $50,752

What is required 1.25 – 1.30

This loan will not be approved. The price would need to be reduced or the buyer needs to put down a higher down payment. The loan amount must be reduced to reach an acceptable DSR.

If the downpayment was increased by $25,000 to $250,000 the ADS of a $500,000 mortgage would be $48,355 creating a DSR of 1.24. Close enough, no. The FED requires a minimum DSR of 1.25. More down or a lower price is required. Also remember some banks want a higher DSR of 30%.

If the price were reduced to $700,000, using a 30% down payment, a $490,000 mortgage ADS would be $47,368 creating an acceptable DSR of 1.27.

In this case if 40% ($300,000) was the down payment a ADS of a $450,000 loan would be $43,502 creating an acceptable DSR of 1.38.

The underlining problem in this example and today are the high interest rates. They are effectively forcing a reduction in value or a higher downpayment to get a mortgage loan.

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