



"Love Your Hat!" What is Your Lender Really Looking at When You Apply for a Commercial Mortgage?

By Frank Gallinelli

When you purchase a piece of income-producing real estate you typically need to secure mortgage financing to complete the deal. It can be helpful and sometimes essential if you know what your lender is looking at when underwriting that loan. If you guessed that he or she is not admiring your millinery, you qualify to read on.

Perhaps the most basic underwriting guideline is the Loan-to-Value ratio. This is the relationship between the amount of the loan (all loans, if more than one is involved) and the value of the property.

Loan-to-Value = Amount of all loans / Lesser of selling price or appraised value

Value has a particular meaning here in "mortgagese." It's the lesser of the selling price or the appraised value. If your cousin, the appraiser, brings in a fantastically high value -- higher than the purchase price -- don't expect the lender to offer you X% of that higher amount. The lender wants to be certain that you have a meaningful chunk of your own money committed to this deal. The more cash you invest, the less likely you are to bail out; and the more likely the bank or mortgage company is to recover the full indebtedness if it has to take back the property and sell it.

Loan-to-Value is just the flip side of down payment. If you make a 10% down payment, you have a 90% Loan-to-Value. When you purchase a home, you can often obtain a loan with a very high Loan-to-Value like 90% or even more, but that is seldom the case with investment property. 80% LTV may be possible, but you'll find that 70% is quite common. The required ratio may be even lower if the property has a highly specialized use.

You can be confident that the lender will also be looking at your property's Debt Coverage Ratio. This measure expresses the relationship between how much money you have available after paying your operating expenses and how much you need to make the mortgage payments. More specifically, it is the ratio between your annual Net Operating Income (Gross Operating Income less operating expenses; see our earlier article, Understanding Net Operating Income) and your Annual Debt Service.

Debt Coverage Ratio = Annual Net Operating Income / Annual Debt Service

If you have exactly the amount of net income needed to meet the mortgage payment, then these two amounts are equal and the ratio is 1.00. Be assured that the lender will not be happy about this. It means the property is producing just enough cash to pay the mortgage. Each lender sets its own DCR requirement, of course, and you need to find out what your lender demands. You should expect that you'll need to meet a DCR of at least 1.20 to 1.25.

An interesting parlor trick that you can perform with DCR is to estimate the maximum loan amount that a property's income could support under a mortgage that has a given rate and term. To do this you have to figure out something called the mortgage constant. A mortgage constant is nothing more than the payment amount on a mortgage of \$1 at a particular rate and term. For example, if you find the payment for a \$1 mortgage at 8% per year for 240 months, you'll have the monthly constant for that mortgage -- 0.0083644. (You can use the free RealData Calculator to do this. Since it calculates payments only to the second decimal place, find the payment for a \$100,000 mortgage and move its decimal point 5 places to the left.)

Once you have the monthly mortgage constant, calculate the following:

Net Operating Income / Debt Coverage Ratio / (Monthly Mortgage Constant x 12)

Say that you have a property with a \$12,500 NOI and you're trying to secure a loan as described above. Your lender has a DCR requirement of 1.25.

$12,500 / 1.25 / (12 \times 0.0083644) = 12,500 / 1.25 / 0.1003728 = \$99,629$ (round to \$100,000)

Of course, this doesn't guarantee you're going to get \$100,00, but it is a good indication that you're not going to get more.



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In addition to the objective measures, there is a subjective consideration that you should take into account: the presentation you make to the lender. If you want to be treated as a professional, you need to make a professional presentation. You should not assume that the property's numbers will speak for themselves or that the lender has all of the necessary and correct information.

If you examine some of the output from our Real Estate Investment Analysis software, in particular the Real Estate Business Plan, you'll see that we put a great deal of emphasis on presentation. This is no accident. It's not enough simply to figure out for your own benefit what the Debt Coverage Ratio or NOI or cash flow will be this year and for the next 20 years. When you make your bid to obtain financing, you want to show the lender that the numbers work and that you know how they work.

What type of information should you present? The Business Plan Report is designed to provide essential information about the investment and to show key rates of return and investment measures -- DCR included -- without overwhelming the reader. If and when the lender requires more detail, you can then use the Annual Property Operating Data, Rent Roll and Cash Flow and Resale Analysis.

Go to the meeting with your lender well prepared. Have the APOD, Rent Roll and cash-flow projections in your briefcase. Have copies of leases, if possible. Prepare a professional Personal Financial Statement as well and bring it with you -- don't wait for the loan officer to hand you a form. (We have done this enough times ourselves that we developed a great and inexpensive program just for this purpose: Personal Financial Statement.)

You're accomplishing two important goals here. You're taking the initiative with the presentation of facts, assuring that the lender is at least starting off looking at the same information as you. You're also demonstrating that you're not a back-of-the-envelope scratcher but rather a serious and knowledgeable investor. I don't believe there are any underwriting guidelines for a borrower's minimum IQ, but if you were lending your own money to a third party wouldn't you feel more inclined to do the deal with someone who exhibited some financial acumen?

Your marching orders are these: Start by finding out not only the lender's loan terms but also the underwriting requirements -- Loan-to-Value and DCR -- for the type of property you want to finance. Then make your financial projections. Determine your NOI, forecast your cash flow, see if you can meet the DCR with the loan amount you're seeking. If the numbers don't work, re-evaluate the deal before you go to the lender; maybe you'll need to invest more of your own cash to reduce the debt service. If and when the numbers do work, build a professional presentation; get the loan; make the deal.