

Commercial Lending 101: How to qualify a deal

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September 26, 2007

CIRCLE BANK

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To begin, you should

Learn the **lingo**.

Understand **traditional** cash-flow analysis.

Learn how **creative** underwriting adds value and gets tough deals closed.

Learn the lingo



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Income

1. Gross Income (GI):

- ▶ Actual GI = current income, as proven by leases.
- ▶ Potential (*proforma*) GI = potential market rents, as supported by the appraisal.



Income

- 2. Vacancy Rate:** typically 5% of GI (per the appraisal), even if the property is 100% occupied.
- 3. Effective Gross Income (EGI):** gross rents less the vacancy allowance.
EGI becomes the basis for calculating many of the expenses.

Expenses

4. **Property Taxes:**

Ask your lender which one they use.

- ▶ Actual: a % of the assessed value.
- ▶ Loan Amount: a % of the loan amount.
- ▶ Market Value: a % of the appraised value.

5. **Insurance:**

Current premiums. Have your client get a quote if the loan amount will change.

Expenses

6. **Replacement Reserves:** 3% of **EGI**, or \$250 per unit per year. Use whichever is higher so you don't get in trouble! This is to replace things that break or wear out.
7. **Maintenance and repairs:** can be 3% of **EGI**. This is for fixing things that break, and for completing regular property maintenance.
8. **Management:** typically 5% of **EGI**, depending on location and property type.

Expenses

9. **Miscellaneous:** typically **4%** of **EGI**, includes utilities, legal, and other real *and imagined* expenses that appear on tax returns (Schedule E).
10. **Expense Ratio:** total expenses divided by **EGI**. It typically falls into common ranges, depending on property and lease type.
11. **Loan Payments:** are *not* an operating expense!

Net Operating Income (NOI)

Formula:

$$\begin{aligned} & \text{EGI} \\ & - \underline{\text{Expenses}} \\ & = \text{NOI} \end{aligned}$$

Debt Service Coverage Ratio (DSCR)

Debt service (**DS**) and loan payments are the same thing.

DSCR is the ratio of **NOI** to **DS**. It expresses cash flow after both operating expenses and loan payments are deducted from **EGI**.

Formula: DSCR = NOI ÷ Debt Service

Every lender determines what the **DSCR** should be for each property type. Riskier property types are underwritten at higher **DSCRs**, providing more of a cushion.

Loan Amount (LA)

Determining the loan amount:

1. Ask for the lender's DSCR guideline.
2. Solve for NOI.
3. Solve for debt service (DS).

$$\text{Formula: } \text{NOI} \div \text{DSCR} = \text{DS}$$

4. Input the loan payments (DS), the qualifying amortization schedule and interest rate into your calculator or amortization software.
5. Solve for **LA**.

This is the key to sizing any deal!

Capitalization Rate (CAP Rate)

Capitalization Rate:

The rate of return on an investment:

Formulas:

$$\text{CAP Rate} = \text{Market Value} \div \text{NOI}$$

$$\text{Market Value} = \text{NOI} \div \text{CAP Rate}$$

CAP Rate is *inverse* to market value:

- ▶ A low CAP Rate = higher price & lower cash flow.
- ▶ A high CAP Rate = lower price & better cash flow.

CAP Rate

Capitalization Rate, continued.

CAP Rates are driven by asset quality, lease type, tenant quality (whether a national company with a credit rating is the anchor tenant), location, etc.

Riskier properties, such as mom and pop hotels, and other labor-intensive, business-oriented properties (self storage, gas stations, etc.) have higher **CAP Rates** than properties leased to quality tenants such as Walgreen's, Burger King, etc.

Gross Rent Multiplier (GRM)

Gross Rent Multiplier (GRM): is the weakest form of value analysis, but commonly used for small investment properties.

Formula:

$$\text{GRM} = \text{Sale Price} \div \text{Gross Annual Rents}$$

GRM *directly* correlates to price:

- ▶ A high **GRM** = a higher price.
- ▶ A low **GRM** = lower price.

What determines loan dollars?

- ▶ **LTV**
- ▶ **DSCR**
- ▶ **Qualifying Rate**
- ▶ **Amortization Schedule**
- ▶ **Actual vs. Projected Income**
- ▶ **Expense Modeling**
- ▶ **Personal Credit Profile**
- ▶ **Property Quality**

Lease types

- ▶ **Full Service:** Owner pays all expenses, unless units are separately metered. Common for apartments and small commercial/mixed-use properties, for which the expense ratio is often 30% to 35% of **EGI** for average properties with market rents.
- ▶ **Double Net (NN) or Gross Lease:** The tenant pays all expenses except for the owner's property taxes and insurance premiums. The expense ratio for this type of lease is often approximately 25% of **EGI**.

Lease types

- ▶ **Triple Net (NNN) or Absolute Triple Net.** The tenant pays *all* of the owner's expenses. Expense ratio can still be calculated, from 5% to 16%, depending on the details...

(You must read the leases to identify who pays for what. One investor's NNN lease is another's NN, and so forth.)

Traditional cash flow analysis

Example: Apartment building purchase.

Purchase Price	\$1,500,000
Allowable DSCR	1.10 : 1
Allowable LTV	75%
Gross Income	\$100,000 per year
Interest Rate	6.75%, fixed for 5 yrs.
Amortization	qualify at interest only

Traditional cash flow analysis

Gross Income (GI)	\$100,000
<u>Less Vacancy Rate (5%)</u>	<u>\$ 5,000</u>
= Effective Gross Income (EGI)	\$ 95,000

Property Taxes	\$ 17,100	(1.14% of PP)
Insurance	\$ 5,000	
Reserves (3% of EGI)	\$ 2,850	
Maintenance (3% of EGI)	\$ 2,850	
Management (5% of EGI)	\$ 4,750	
<u>Miscellaneous (4% of EGI)</u>	<u>\$ 3,800</u>	
= Total Expenses	\$ 36,350	

Net Operating Income (NOI) **\$ 58,650**

Traditional cash flow analysis

Expense Ratio: 38.30%

NOI: \$58,650

Allowable DSCR: 1.10 : 1

Calculate Debt Service:

NOI ÷ DCR = Debt Service (DS)

$\$58,650 \div 1.10 = \$53,318$

Calculate Loan Amount:

DS ÷ Rate = Loan Amount (LA)

$\$53,318 \div 6.75\% = \mathbf{\$789,899}$

LTV = 53%

(Oy Vay!)

In the SF Bay Area, CAP Rates are low, GRMs are high. Even with favorable, low-rate interest-only loans, *huge* down payments are necessary to achieve positive cash flow.

Creative commercial underwriting

Is there a better way?

Circle Bank blends the traditional cash-flow underwriting of commercial lending with the debt-to-income (**DTI**) personal credit analysis used in residential lending. This hybrid underwriting method allows *higher LTVs*, which means more cash in the buyer's pocket.

- ▶ DSCRs as low as .70 : 1.
- ▶ Personal DTI ratio as much as 50%.
- ▶ Exceptions case-by-case.

Underwriting a negative cash flow

- ▶ At **Circle Bank**, we calculate the difference between the NOI and the loan payment.
- ▶ The difference is then added to the borrower's *personal* debt load, like a car payment.
- ▶ We then calculate the borrower's projected *personal* debt-to-income (DTI) ratio. Debts include monthly housing costs plus all other monthly obligations, including the projected negative. Income is taken from tax returns and year-to-date income.
- ▶ *If the total ratio is 50% or less, we are within the guidelines.*

The Circle Bank apartment analysis

Gross Income (GI)	\$100,000
<u>Less Vacancy Rate (5%)</u>	<u>\$ 5,000</u>
= Effective Gross Income (EGI)	\$ 95,000

Property Taxes	\$ 17,100	(1.14% of PP)
Insurance	\$ 5,000	
Reserves (3% of EGI)	\$ 2,850	
Maintenance (3% of EGI)	\$ 2,850	
Management (0% EGI)	\$ 0	
<u>Miscellaneous (4% of EGI)</u>	<u>\$ 3,800</u>	
= Total Expenses	\$ 31,600	

Net Operating Income (NOI) **\$ 63,400**

The Circle Bank apartment analysis

Expense Ratio: 33.30%

NOI: \$63,400

Allowable DSCR: .70 : 1

Calculate Debt Service: **NOI ÷ DCR = Debt Service (DS)**

$$\$63,400 \div .70 = \$90,571$$

Calculate Loan Amount: **DS ÷ Rate = Loan Amount (LA)**

$$\$90,571 \div 8.125\% \text{ (I/O)} = \mathbf{\$1,114,725}$$

LTV = 74.3%

Oye Como Va! Hear the music!

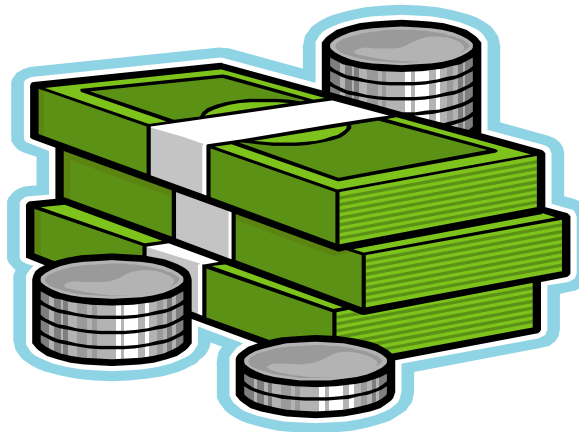
Circle Bank's non-traditional approach lets the buyers keep *more money* in their pockets, which is better used to improve the property which increases the rental income, and thereby increasing the value of the property.

Comparison: traditional vs. creative

	Traditional	Circle Bank	Difference
Purch. Price	\$1,500,000	\$1,500,000	
GI	\$100,000	\$100,000	
Rate	6.75%	8.125%	+ 1.375%
Payments	360	Interest only	
Amortization	360	Interest only	
NOI	\$58,650	\$63,400	+ \$4,750
Exp. Ratio	38.30%	33.30%	- 5%
DSRC Ratio	1.10	.70	- .40
DTI Ratio	?	50%	
LTV	53%	74.3%	+ 21.3%
Down Pmt.	\$711,000	\$385,275	- \$325,725
Max LA	\$789,000	\$1,144,725	+ \$345,725

Creative commercial underwriting

Mo' money for your borrowers!
Mo' rebates for you!



The Circle Bank advantage

- ▶ .70 DSCRs on purchases of *all property types*.
- ▶ No management expense for owner-operators.
- ▶ Actual property taxes on refinances.

- ▶ “Make-sense” streamlined decisions.
- ▶ Down payments as low as 15% (75-10-15).
- ▶ Stated income to 60% LTV.

- ▶ “Strong” borrowers buying “weak” properties OK.
- ▶ Global cash flow underwriting.
- ▶ Creative solutions.
- ▶ Rebates!

Conclusion

- ▶ **Don't get caught in the commodity trap.** Identify your client's needs, and offer value-added solutions.
- ▶ **The lowest rate isn't always the best deal.** Can your clients make more money by leveraging a purchase? With a smaller down payment, they can preserve their liquidity, make improvements, increase their cash flow and increase the value of the property. Or buy another investment property.

Conclusion

- ▶ **Circle Bank's hybrid underwriting** approach puts more money on the table for your borrowers. Most professional investors and commercial Realtors[®] don't know that they can get purchase money loans with DSCRs as low as .70. So spread the word, and position yourself as a "Value-Added" professional.
- ▶ **Information is power.** Now that you know how to "size" commercial loans, you can add more value to your clients' transactions and build your business in a new direction.
Go forth and thrive!

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Please call me to help you size your deals.
I wish you success!

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