Commercial Lending 101:
How to qualify a deal

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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

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!

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Net Operating Income (NOI)

Formula:

EGI

- Expenses

= NOI

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 **DSCR**s, 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).

Formula: NOI ÷ DSCR = 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:

CAP Rate = Market Value ÷ NOI

Market Value = NOI ÷ 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:

GRM = Sale Price ÷ Gross Annual Rents

GRM *directly* correlates to price:

► A high **GRM** = a higher price.

► A low **GRM** = lower price.

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What determines loan dollars?

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

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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	
Less Vacancy Rate (5%)	$ 5,000	
= 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	
Miscellaneous (4% of EGI)	$ 3,800	
= 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 ÷ 1.10 **=** $53,318

Calculate Loan Amount: **DS ÷ Rate = Loan Amount (LA)**
$53,318 ÷ 6.75% = **$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.

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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	
Less Vacancy Rate (5%)	$ 5,000	
= 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	
Miscellaneous (4% of EGI)	$ 3,800	
= 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 ÷ .70 = $90,571

Calculate Loan Amount: **DS ÷ Rate = Loan Amount (LA)**
$90,571 ÷ 8.125% (I/O) = **$1,114,725**

LTV = 74.3% Oye Como Va! Hear the music!

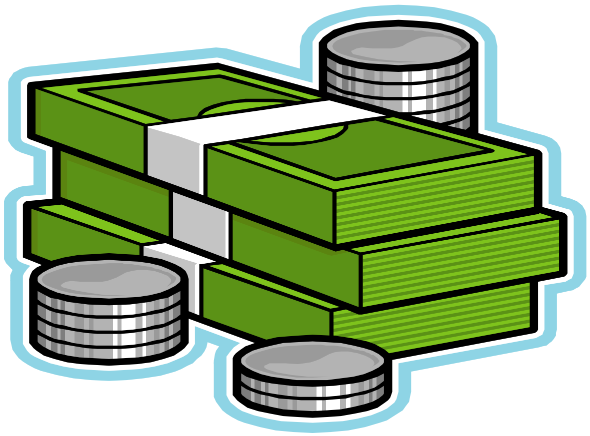
Circle Bank's non-traditional approach lets the buyers keep *more money* in their pockets, which is better used to improve the property which increases the rental income, and thereby increasing the value of the property.

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!



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.

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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Go forth and thrive!

Please call me to help you size your deals.

I wish you success!

Mark Skolnick • Circle Bank

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