UNDERSTANDING COMMERCIAL LOANS

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CHAPTER 1

INTRODUCTION TO COMMERCIAL LOANS

Commercial Loans are defined as: "Any real estate loan not secured by residential property (i. e. #1 to 4 unit residences)."

The most common types of commercial loans involve the following types of properties:

- Apartments
- Office Buildings
- Retail Buildings
- Warehouses and Other Industrial Buildings
- Land Developments

There are a number of differences between commercial loans and residential loans. Some of the major differences are shown in the following table:

ISSUE	RESIDENTIAL	COMMERCIAL
CREDIT	Very Important	Less Important
DOWN	As Low as 0	20% to 30%
BORROWER INCOME	Very Important—Rigid Ratios	Not an Issue
DEBT SERVICE COVERAGE RATIO	N/A	Very Important
MANAGEMENT	N/A	Very Important
RESERVES	Taxes & Insurance	Taxes, Insurance & Replacements

Other Differences: Other ways in which commercial loans differ from residential loans are as follows:

- With commercial loans the evaluation of the property is more important than the evaluation of the borrower (*many larger commercial loans are non-recourse*)

- An appraisal (*usually done by an MAI*) and the property's operating history and forecast of operations are extremely important

- Larger loans (*over $10 million*) are easier to get than smaller loans (*under $1 million*)

- On larger loans, terms are quite negotiable and terms are often custom tailored to the needs of the borrower and the characteristics of the property

- Except for apartment loans, amortization periods are typically 15 to 25 years (l*ow income apartment loans can be up to 40 years*)

- It is common to have final balloons due before the end of the amortization period (*10 years is quite common*)

- Interest rates on conforming commercial loans are typically 1% to 2% higher than for conforming residential loans

- Adjustable or variable interest rates are far more common

- It is quite common to require annual financial reports on property operations and, in some cases, an audited financial statement is required

- Annual property inspection by the lender's representative are often required

CHAPTER 2

UNDERWRITING COMMERCIAL LOANS

The underwriting of commercial loans is similar to underwriting residential loans in that loan to value ratios (*LTV*) are quite important. In residential loans a 90% LTV is quite common and it is also possible to get 100% LTV loans and in some cases even 125% LTV loans. In the case of commercial loans LTV's are much lower and typically in the range of 65% to 85% of value.

An important underwriting formula in commercial loans is the Debt Service Coverage Ratio (*DSCR*). This is a formula that can often create disappointment for the first time investor or the real estate licensee not familiar with commercial lending. Most first time investors or inexperienced licensees will usually be aware of the lenders loan to value ratio and will therefore structure a purchase transaction based upon the assumption that they can get a loan for the maximum LTV. Unfortunately, the policy of lenders is to underwrite the loan based upon the lower of the loan amount indicated by LTV or the DSCR.

Definition of Debt Service Coverage Ratio (DSCR): The DSCR is defined as:

> "A ratio between the net operating income (*NOI*) produced by the property and the annual payments required by the debt securing the property."

To demonstrate how the DSCR works lets assume the following facts:

Property Value	$1,000,000
Proposed Loan Amout	$750,000
Interest Rate	6.5%
Amortization Period	20 Years
Monthly Payment	$5,591.80
ANNUAL DEBT SERVICE (Rounded)	$67,102

Now let's assume that the above property had the following income:

Gross Income	$190,000
Less: Vacancy & Collection Loss	-9,500
Less: Operating Expenses	-80,500
NET OPERATING INCOME	$100,000

As the above definition explains, the DSCR is the net operating income divided by the annual debt service. Therefore in this case the DSCR is 1.49 ($100,000/$67,102=1.49).

Another Example: Now let's assume that for the property in the above example that the loan terms have been changed increasing the interest rate from 6% to 9% and decreasing the amortization from 20 years to 15 years. This calculation would result in Annual Debt Service of $91,283. Now using the calculation of dividing the net income by the annual debt service, the new DSCR is calculated at 1.10 ($100,000/$91,283=1.10). Do you see what impact rising interest rates could have on loan amounts, even if all other factors remain the same?

Now let's see how large a loan is available to purchase the property in this example: If the lender requires a DSCR of 1.25, the maximum Annual Debt Service is calculated as $80,000 ($100,000/1.25=$80,000). In the first example with a 6%, 20 year loan the annual debt service

was only $67,102 on a 75% LTV loan. Therefore in that case, the maximum loan available would be $750,000.

However, in the second part of the example, with a 9% loan and 15 year amortization, the calculated annual debt service was $91,283 which is more than the maximum of $80,000 allowed by the lender's 1.25 DSCR. In this case, since $80,000 is the maximum annual debt service the maximum loan that could be paid with that amount of debt service, assuming 9% interest and 15 years amortization, is a loan of $657,290. Therefore in this case, the maximum LTV would be only 65.73%.

As the above examples demonstrate it is important to know all of the lenders underwriting criteria because changes in the interest rate or amortization period can reduce the maximum loan to less than is indicated by the lender's quoted and maximum LTV.

CHAPTER 3

TYPES OF COMMERCIAL LOANS

There are many different types of commercial properties and each property has different income characteristics. As a result, the underwriting criteria used by Lenders will vary according to property. However, broadly speaking there are two basic types of commercial loans:

- Conforming - Credit and Income Based Loans
- Asset Based Loans

Conforming – Credit and Income Based Loans: Such loans are secured by conventional properties, involve Borrowers with good credit, and properties with debt service coverage ratios (*DSCR*) meeting the lenders standards. Typical loans in this category would include loans secured by good quality apartment buildings, office buildings, strip retail centers, good quality warehouses, shopping malls, and generally any type of good quality commercial property that has an acceptable DSCR.

Such loans are usually made by institutional lenders (*banks, insurance companies, etc.*) and government agencies (*such as the Alaska Housing Finance Corporation and/or the Alaska Industrial Development and Export Authority*) which may actually make the loan or participate with a bank in making the loan. In other cases, particularly those involving owner occupied businesses, the loan may be made by an institutional lender but may be insured by the Small Business Administration.

Conforming Loans are very desirable to the Borrower in that they usually have the highest loan to value ratio, which is typically 75% for most commercial properties but can be as high as 85% for apartment properties. Because the loans are secured by good quality conforming properties with good debt service coverage ratios, such loans will have the most favorable interest rates. For long term real estate investments to be profitable it is almost always necessary to finance the property with a conforming loan and, even when Asset Based Loans are used, the Borrower's goal should be to eventually get a Conforming Loan.

The only draw back of Conforming Loans is that the loan will be subject to rigorous underwriting which will require the Borrower to supply a lot of documentation on the property and personal information. Such loans will usually require annual financial reporting and may be subject to very extensive regulatory agreements governing the property operations. It is not uncommon for such loans to require an annual inspection by a representative of the Lender and to require annual financial reports on both the Borrower and the property. In certain cases, such as some of the AHFC loans and some of the FHA loans, annual audited financial statements will be required. Quite often such loans will require a monthly contribution to a replacement reserve for short lived items.

Assets Based Loans: Such loans are also known as "*bridge loans, hard money loans, un-bankable loans, or non-bankable loans*." Typically, such loans are not made by institutional lenders although there are some exceptions. Primarily, these types of loans are made by private investors not subject to any form of government regulations.

Asset Based Loans will, typically, have lower LTV's than Conforming Loans. Most LTV's range from 55% to 70%, but many Assets Based Lenders will allow Seller Seconds up to a 95% combined loan to value ratio.

A typical use of an Asset Based Loan would be on a non-conforming property or property which does not have sufficient income to support a Conforming Lender's required DSCR. For this reason, Asset Based Loans will usually have interest rates substantially greater than the interest rates for Conforming Loans. On the other hand, they usually have easier underwriting, with Borrower credit and DSCR not being major issues in the Lender making the decision as to whether or not to make the loan.

Asset Based Loans are usually underwritten on an individual basis and often have very flexible terms that are negotiated to fit the situation.

Therefore, they are good for situations that are unique and/or involve unique properties that don't qualify for Conforming Loans. Some of the best uses of Asset Based Loans are when time is critical or the need for financing is only for a short period of time such as 1 to 5 years. Asset Based Loans are excellent for the purchase of properties requiring rehabilitation, where the property will be suitable for Conforming Financing after the rehabilitation has been completed.

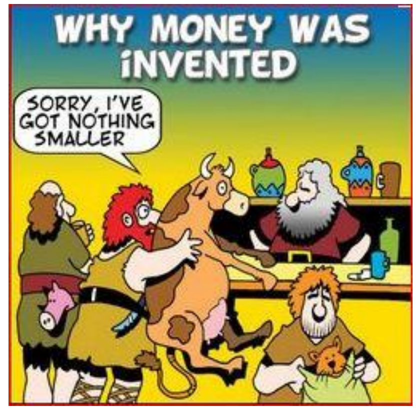
Due to high interest rates, Asset Based Loans are usually not suitable financing for long term holding of an investment property.

Summary: Commercial Financing is usually more flexible than residential financing. Usually some negotiation is possible and therefore a good understanding of Creative Financing is a good background for Commercial Financing.

CHAPTER 4
CREATIVE FINANCING

Commercial properties can be bought and sold using Creative Financing in the same manner that such financing is used with residential properties.

In the olden days, property was sold using barter and exchange. And if you stop and think about it, every transaction involves an exchange. Money is only the medium that makes transactions easier. With the possible exception of Scrooge McDuck, no one sells a property just to get money! They may say that, but the reason they want money is so they can use the money to buy something that they want more than the property they are selling. By learning why people are really selling, it is often possible to satisfy their wants and needs without a Buyer qualifying for a loan.

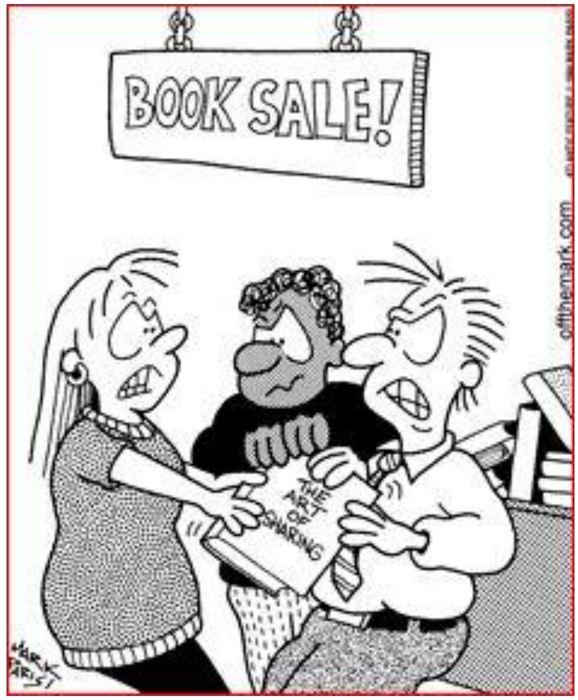


By knowing, and using the **Five Pillars of Creative Real Estate,** it is possible to close a transaction without a Buyer qualifying for a loan. These Five Pillars, and a short explanation of how to use them is as follows:

- **Barter & Exchanges**—The Buyer can pay all or part of the purchase price by giving the Seller something that the Seller would buy with money from a cash sale. The same applies to the real estate commission.

- **Assumptions**—With today's stagnant market, many Sellers have little or no equity and therefore Buyers with little cash can assume the loan. While the "Due on Sale" clause is a theoretical problem with assumptions, it his highly unlikely that a Lender will call a loan due if the payments are being made, taxes are being paid and the property is insured.

- **Seller Financing**—This time proven technique is extremely flexible and allows for structuring of financing to meet the needs of both Buyers and Sellers. And with **CA$H NOW SELLER FINANCING** the Seller can sell all or part of the Note at the closing table for cash. You can download a Free eBooklet on this important technique at **www.CreativeRealEstateTalk.com.**



- **Shared Equity**—There are many ways of sharing equity with several individuals to structure a transaction that will close. One common form (*often between parents and children*) is to have one party invest a substantial amount as a down payment to facilitate the other party to qualify for a loan. They then become co-owners in the property and share in the equity based upon their agreement. Many commercial properties are bought by investment groups through Limited Partnerships or Limited Liability Companies.

- **Options and Rent to Own**—Although title to the property does not immediately transfer with these techniques, they can be used effectively to let a Buyer gain occupancy and to relieve a Seller of the risk and expense of a vacant property.