

Underwriting Commercial Loans

The objective of this study is to understand the basic principles of underwriting for multifamily housing and commercial real estate loans. As a mortgage broker, real estate agent, investor or lender, your primary objective is to make sure the loan secured by the property makes sense for the lender and borrower. However, there is a gray side to the credit decision when approving a commercial loan that makes each transaction unique.

Loan Types

There are two types of loans. Secured and unsecured. This discussion will focus on secured loans, because the promise to repay all real property loans is secured by the real estate. Loans made on residential property of 5 rental units or more, and on other commercial or industrial properties are referred to as commercial loans.

Property Quality Categories

Property quality is divided into two major categories: prime and sub-prime. Prime property is higher quality property, often referred to as Class A property. Sub-prime properties are all other properties that do not qualify as prime properties. From a lending perspective, both are equally desirable, provided there is good borrower credit and sufficient cash flow to service the proposed debt.

Prime real estate includes well-maintained multifamily properties in very good to excellent condition, situated in good to excellent areas. A balance of bedroom and bath configuration, together with solid positive historical operating experience aids in upgrading a property, from a lender's perspective. Lenders for commercial real estate loans can offer the best loan rates and terms, however they tend to be more discretionary about the properties against which they choose to lend.

The prime multi-family includes property that has a unit mix of mostly two or more bedrooms per unit, plenty of parking and a well-maintained property that has little or no deferred maintenance. The unit mix can include single and one-bedroom units, but ideally those should remain less than 20% of all the apartment units in the building.

Commercial lenders are always concerned about risk. For example, a commercial property with a "credit tenant" is a lower risk than a property without a credit tenant, or one with tenants on short term leases. Short-term leases often results in frequent tenant turnover and increased costs associated with turnover. Therefore, one of the first considerations in evaluating the strength of a commercial loan is the strength and creditworthiness of tenants and the length of their leases. Other risk factors include quality of construction, deferred maintenance and lower overall property attributes that create higher risk for the lender.

Sub-prime multi-family properties, for example, can include apartments with mostly bachelor and one-bedroom units, limited parking, older buildings with deferred maintenance or situated in low rental demand areas. These are risk factors for which borrowers will pay a higher premium on the cost of credit as such properties are considered higher risk than prime properties.

Underwriting Elements

There are two principal elements of underwriting. First is the **asset**, which is the security for the repayment of the proposed loan. Second is **credit**, which includes the borrower's overall ability to act as a secondary source of repayment in the event there is an unanticipated reduction in income from the asset. Therefore, creditworthiness is a function of the willingness and ability to repay debt. The willingness is demonstrated in the credit score, while the ability is demonstrated in the overall financial strength of the borrower. These two characteristics are separate but work in unison in the underwriting process. However, within these two categories, there will exist a gray area.

The gray area of a credit decision means there is an accumulation of strengths and weaknesses within both the asset and credit elements. A credit officer must divide the strengths from the weaknesses and weigh them. One side is the weaknesses, or risks of the transaction. The other side are the strengths and risk mitigation of the transaction. The scale will most often tip towards one side or the other. The most practical way to view that scale of strengths and weaknesses is on paper. Almost every commercial property, especially sub-prime, has some type of negative factor, be it in the asset or credit of the borrower, or both. Lenders are very aware of this and appreciate receiving loan applications that identify the weak areas of a transaction, as well as the strengths. This also helps determine if the risks attendant the application can be overcome with other mitigating factors.

Approaching a lender with the strengths and weaknesses of a transaction clearly defined will gain their full attention—and respect. The following are a few strengths and weaknesses for each type of investment property.

Strengths & Weaknesses: Multifamily

<u>Subject Property</u>	<u>Strength</u>	<u>Weakness</u>
Age:	New or less than 15 years	Old, typically greater than 15 years
Maintenance:	No deferred maintenance	Deferred maintenance or rehabilitation
Construction:	Wood & Stucco	Brick structure (not facades)
Parking:	Parking up to code, secured, or with garages	Little or no onsite parking
Utilities:	Individual metered	Master Metered
Unit Mix:	Good mix of 2 & 3 bedrooms	More than 20% bachelor/single units.

Strengths & Weaknesses: Commercial

<u>Borrower:</u>	<u>Strength:</u>	<u>Weakness:</u>
Reserves: - cash, stocks	Cash reserves = 6 mos. pmts 2% or more cash-to-assets	Less than 6 months pmts. Less than 2% cash-to-assets
Management:	Seasoned investor/manager	New to real estate investments/mgmt.
Credit:	FICO above 620 (B), 680 (A) Available revolving credit high % Reasonable number of open accts. Real estate credit paid as agreed	FICO below 600 (C credit) Available revolving credit low % Excessive number of open accounts Real estate credit derogatory
Sources of Income	Stable or increasing income Employed at same job for 2 or more years	Erratic or declining historical income New job, self-employed less than 2 yrs.

The items above are just a few, but most important of the many strengths and weaknesses that are considered. An assessment of the foregoing will serve as a quick overview to determine if proceeding with a loan application is warranted.

Commercial Loan Application

The following are the items, at a minimum, that should be included with every commercial loan application:

1. Cover page with loan purpose or lender submission page
2. Photos (front, back, sides and up-and-down street scene)
3. Rent roll
4. Current income and expenses, expressed monthly
5. 2 year historical income & expense, expressed annually
6. Tax returns including all schedules
7. Credit application (form 1053)
8. Current credit report with written explanation of any derogatory credit
9. 2 years federal and state individual income tax returns including all schedules
10. Purchase documents, if applicable

Income, Expense & Estimated Value Analysis

The last page of this study includes a form that contains 14 line items which are discussed below.

1. Gross Scheduled Income

The gross scheduled income is the subject property's gross annual income, calculated if 100% occupied.

2. Other Income

Properties can have income from other sources, such as parking, storage, collection and late fees, fees imposed for special services under a tenant's lease, common area maintenance fees, expense reimbursements which for example, can include income from tenants for property taxes and insurance, plus interest on funds held on deposit. Apartment buildings often have laundry income as well. All of that, for the purposes of conducting a summary analysis, can be lumped together as other income.

3. Adjusted Gross Income

The Gross Scheduled Income together with any Other Income is referred to as the Adjusted Gross Income.

4. Vacancy Allowance

Every property that is rented, whether a retail strip center, shopping mall, office building, apartment building, industrial complex, etc., has periods of partial vacancy. In allowing for this, a vacancy factor that is either consistent with the operating history of the property or congruent with the area must be included, even if the property is currently 100% occupied.

For commercial retail shopping centers, there is Common Area Maintenance (CAM) expense. Most retail shopping centers have leases that require tenants to pay their pro rata share of the maintenance and taxes for the common area. Common areas include sidewalks, parkways, parking areas, grounds and landscaping and other parts of the property used by all tenants and their guests.

The industry-standard rule for vacancy is 5% in a good economy. Absent any specific information from the borrower; the property history or current area vacancies for similar property types, use 5% as a vacancy factor.

If you know for that a certain building is located in a high demand neighborhood, then research the actual vacancy. Because of demand, some areas of various cities have a vacancy of less than 3%, or no vacancy and a waiting list. Some areas rarely see a vacancy. However, because businesses and people do move from time to time, there will almost always be some loss of revenue. Even if its revenue lost solely for the time required to make the rental space ready for a new tenant, that is nevertheless lost income. Most appraisers deem it necessary to enter a vacancy factor because of loss of revenues due, at a minimum, to costs associated with tenant turn-over, even when there is a waiting list. This also creates a 5% gross income 'pad' for unanticipated expenses.

5. Effective Gross Income

This is the product of the Adjusted Gross Income less Vacancy allowance, and is referred to as the property's Effective Gross Income (EGI).

6. Expenses (Example: For Multi-Family Apartments with 5 or more Units)

The expenses are the most difficult to determine. Apartment expenses range from 32% to 42% of EGI, however, if you want to use a quick calculation, use 38% of the EGI on smaller apartments from 5 to 12 units, and 32% on larger apartment projects. If the electricity for the apartment building is master metered (one electrical meter for all apartment units), use a figure equal to 50% of EGI for expenses.

Historical expenses should be less than your own estimation, especially for smaller buildings. That is because many of the apartment buildings are self-managed and do not include reserves and replacement costs into account. The previously estimated expenses take reserves and management costs into account. The appraiser will include management and reserves for replacements (such as stoves, roof, HVAC units etc).

For commercial properties, you can use a 38% of EGI for expenses as well. However, when estimating expenses for properties with triple net leases, an expense load of 12% of EGI should be sufficient.

Expenses on commercial properties are impacted by the lease type and terms of the tenant leases. Leases set out which expenses are paid by the landlord and which are paid by the tenant. Expenses paid by the tenant can be direct expenses, or reimbursements to the landlord for such expenses. The different types of leases are "net" and "modified gross". Each type is dependent upon what expenses are paid by the borrower (modified gross) or tenant (net). In a net lease, the reimbursed expenses may include property taxes, property insurance and CAM charges. In a modified gross lease, the tenant does not pay any of the above items. As a result, when approximating expenses for a building using modified gross leases, the higher expense estimate of 38% is indicated.

Retail shopping centers and regional malls often require the tenants to pay net leases, in which the tenant pays their pro rata share of property taxes, insurance and common area maintenance, (CAMs). Net leases are typical for high-demand retail property.

Appraisers use an expense calculation for retail property, using national standards averaging from \$2.25 to \$3.50 per square foot annually. A good average to use in estimating operating expenses for these property types is \$2.50 per square foot. Retail property with a mix of different lease types should be handled differently, however. Take the last three years historical expenses, including management, which will average 3% of gross income. If expenses for the property are increasing or fluctuating, use the highest number and add 2% for reserves, 3% for management (if not already included) and 3% for inflation (estimate)..

Office building expenses average \$5.00 to \$5.75 per square foot annually. If you apply the 38% expense rule, double check the expenses by dividing your estimated expenses by the annual net rentable square footage. It should fall in the range of \$5.00 to \$5.75 per square foot. Otherwise, something may be wrong with the expenses as estimated, or the income may be below market. When considering expense figures, do not include debt service, depreciation or amortization.

7. Net Operating Income

The Net Operating Income is the product of EGI less operating expenses (line 5 less line 6).

8. Annual Debt Service

This is the annual charge for debt secured by the property, when considering the costs for the proposed loan. While some loans may offer interest-only payments, or others interest at variable rates, it is important to calculate the payment on a fully-amortized basis. This is the maximum amount of debt the property would have to pay absent any special payment terms. This is also referred to as the 'fully-indexed' rate, as it includes the margin imposed by the lender over the loan index (prime, treasury, LIBOR, etc). The exception to using the fully-indexed rate is if the loan is a short-term loan (1-to5 years) and is intended to be interest only, or where the interest rate is fixed over the life of the loan or for a period certain, such as 5, 7 or 10 years. In such cases, the fixed rate of interest instead of a fully-indexed or fully-amortized loan rate can be used in calculating the amount of debt the property can support.

9. Debt Coverage Ratio

The next step is to make sure that the subject property has enough cash flow to service the new debt (the ability to make the new payment) and remain profitable. There is a simple formula for making this determination. Gross income, less all regular operating expenses, before debt services is known as net operating income ("NOI"). Therefore, the NOI is the amount of income after expenses available to service debt. There must be more NOI than the cost of debt service, so the property realizes a cash flow. There is a standard ratio between the amount of the NOI and the amount of the debt service over a corresponding period, where NOI is divided by debt service, for example:

Annual NOI	\$125,000
Annual Debt Service	80,000
Ratio	1.56 i.e., for every dollar of debt service, there is \$1.56 of NOI

This ratio is referred to as the debt coverage ratio (DCR) or the debt service coverage ratio (DSCR).

Every lender will have a list of minimum DCR standard, which vary depending on property type. Higher risk properties will require a greater DCR, for example, and in order of typically-perceived risk: industrial buildings may require a DCR of 1.65; retail 1.50, apartments 1.20 or less.

10. Debt Service Income

Debt Service Income is determined by applying the DCR to the Cash Flow and arriving at the maximum annual debt service payment.

11. Cash Flow

This represents the net income from operations, after expenses and debt service. This is the property owner's pre-tax income from the property, before depreciation and amortization.

12. Loan Amount

The loan amount is determined by imputing the fully-indexed, or fixed interest rate into the present Debt Service Income to calculate loan payment and arrive at the principal amount which that loan payment, based on that interest rate, will support. This calculation is easiest achieved using a financial calculator, such as a Hewlett Packard® 12C calculator, other calculators and amortization tables are available online.

For example, assume the following facts for an apartment loan, fully-indexed at 7.25%, 30-year amortization:

Net Operating Income	\$125,000
Lender-imposed DCR	1.15
Debt Service Income	\$108,965

To determine the amount of the loan, the question is “How much debt will \$108,965 service at a 7.25% rate of interest over 30 years. Answer: \$1,331,095.

In calculating commercial loans, always round down to the nearest thousand dollars, therefore the maximum loan that could be requested in this example would be \$1,330,000.

13. Estimated Value

One of the truly wonderful aspects of income properties is that, unlike stocks, jewelry, art or other assets subject to subjective values, the truest measure of value of income properties is based their net operating income, which is a clearly-defined amount. Remember, NOI is income before debt service. It represents the amount of income the property owner would realize if they had no debt service.

In commercial real estate, there is a common term: CAP Rate. Simply put, this is a capitalization rate. The CAP Rate answers a basic investment question: What rate of return would be needed to attract capital into a specific investment? That rate of return is the CAP rate for that investment.

For example, if the return on a 5-year bank certificate of deposit is 5.05%, and that is sufficient to attract investor interest in investing in those certificates, it could be said then, that the CAP Rate for those 5-year certificates is 5.05%.

In commercial real estate, the CAP Rate is paramount in determining what rate would be necessary to attract capital into any income property. The CAP Rate is a function of property type, risk, property location, desirability, operating history and stability of income, among other factors. When applying the CAP Rate in income property, it must be applied to the NOI. Similar to purchasing CD's for all cash to produce a certain yield, the purchase of an income property for all cash would produce a certain yield.

Rate Follows Risk. The higher the CAP Rate, the greater the perceived / calculated risk, and therefore a higher return is required to attract capital into that investment to compensate for the higher risk. The lower the actual or perceived risk, the lower the CAP Rate. Bank CD's are guaranteed investments, with no risk. Therefore, their rate of return is lower than other investments that do not have a guaranteed return.

In calculating CAP Rate for income properties, always apply the CAP Rate to the NOI. Therefore, in the example above, where the NOI is \$125,000, and if the CAP Rate for that investment was 7%, the value of the asset, based on its income would be the product of 7% divided by \$125,000. This is to say, how much capital would have to be invested at 7% to yield \$125,000 per year? The answer of course, is \$1,785,714. Therefore, the indicated value of the income property would approximate \$1,785,700.

14. Loan Program

The loan program is the anticipated loan type: fixed or variable, and loan term. The start rate is the initial interest rate for the loan program selected. The fully-indexed rate is the note rate including the lender's margin.

15. Loan-to-Value

The loan-to-value is the ratio of the loan amount to the property value, for example. Assume the amount of the loan is as stated in paragraph 12: \$1,330,000. Further assume the value of the property is as stated above in paragraph 13: \$1,785,700. Therefore, to determine the loan-to-value, divide the loan amount by the property value: \$1,330,000 divided by \$1,785,700. The product of that calculation is 74.448%, rounded to 75%, meaning that the loan amount as requested is 75% of the value of the property. Therefore, the lender will be at risk 75%, and the property owner 25%. This ratio is typical for apartments and most commercial, but not industrial or manufacturing properties. Industrial and manufacturing loans-to-value are typically 60~65%.

The gross rent multiplier (GRM) is another method of comparing asking prices or values between properties, with respect to the subject property, in determining if the value as determined by the capitalization of the NOI (in paragraph 13) is reasonable. Gross rent multipliers work in a similar fashion as CAP Rates, but are a multiple of gross income, and are determined by multiplying the gross income by a certain factor, whereas CAP Rates are determined by dividing the NOI by a certain factor.

In the examples used above, where the estimated value of the property (in paragraph 13) approximates \$1,785,700. If the GRM for the area is for example, 6, that would mean the gross income would have to be approximately equal to the product of the value (\$1,785,700) divided by 6. Therefore, for illustrative purposes, that would indicate gross income approximating \$297,617. the property would then be said to be valued at 6X's gross.

Therefore, in the foregoing example, the property is of a type and in an area and condition, etc., that warrants a 7 CAP, and its price/value is based on 6X's gross.



Income, Expense & Estimated Value Analysis

1. Gross Scheduled Income \$ _____
2. Other Income: _____
3. Adjusted Gross Income _____
4. Vacancy Allowance _____
5. Effective Gross Income (EGI) _____
6. Less Expenses (actual or estimated) _____
7. Net Operating Income (NOI) _____
8. Annual Debt Service _____
9. Debt Coverage Ratio _____
10. Debt Service Income (Debt Payment) _____
11. Cash Flow _____

Proposed Financing:

12. Loan Amount _____
13. Estimated Value (NOI/capitalization rate) _____
14. Loan Program: _____ Start Rate: _____ % Fully Indexed Rate: _____ %
15. Loan-to-Value: _____ Gross Rent Multiplier: _____ Cap Rate: _____