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What Investors Should Know About Commercial Real Estate Loans

By David V. Tran

Your commercial real estate transaction does not close unless the loan is approved. You can also improve the cash flow if the interest rate for the loan is low. So the more you know about commercial loans, the better decision you can make about your commercial real estate investment.

Loan Qualification: Most of you have applied for a residential loan and are familiar with the process. You provide to the lender with:

- W2's and/or tax returns so it can verify your income,
- Bank and/or brokerage statements so it can verify your liquid assets and down payment.

In general the more personal income you make the higher loan amount you qualify. You could even borrow 95% of the purchase price for 1-unit principal residence with sufficient income.

For commercial loan, the loan amount a lender will approve is based primarily on the net operating income (NOI) of the property, not your personal income. This is the fundamental difference between residential and commercial loan qualification. Therefore, if you buy a vacant commercial building, you will have difficult time getting the loan approved since the property has no rental income. However, if you

- Occupy at least 51% of the space for your business; you can apply for SBA loan.
- Have sufficient income from another commercial property used as cross collateral; there are lenders out there that want your business.

Loan to Value: Commercial lenders tend to be more conservative about the loan to value (LTV). Lenders will only loan you the amount such that the ratio of NOI to mortgage payment for the loan, called Debt Coverage Ratio (DCR) or Debt Service Ratio (DSR) must be at least 1.25 or higher. This means the NOI has to be at least 25% more than the mortgage payment. In other words, the loan amount is such that you will have positive cash flow equal to at least 25% of the mortgage payment. So, if you purchase a property with low cap rate, you will need a higher down payment to meet lender's DCR. For example, properties in California with 5% cap often require 50% or more down payment. To make the matter more complicated, some lenders advertise 1.25% DCR but underwrite the loan with interest rate 2%-3% higher than the note rate! Since the financial meltdown of 2007, most commercial lenders prefer keeping the LTV at 70% or less. Higher LTV is possible for high-quality properties with strong national tenants, e.g. Walgreens or in the areas that the lenders are very familiar and comfortable with. However, you will rarely see higher than 75% LTV. Commercial real estate is intended for the elite group of investors so there is no such thing as 100% financing.

Interest Rate: The interest for commercial is dependent on various factors below:

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1. Loan term: The rate is lower for the shorter 5 years fixed rate than the 10 years fixed rate. It's very hard to get a loan with fixed rate longer than 10 years unless the property has a long term lease with a credit tenant, e.g. Walgreens. Most lenders offer 20-25 years amortization. Some credit unions use 30 years amortization. For single-tenant properties, lenders may use 10-15 years amortization.

2. Tenant credit rating: The interest rate for a drugstore occupied by Walgreens is much lower than one with HyVee Drugstore since Walgreens has much stronger S&P rating.

3. Property type: The interest rate for a single tenant night club building will be higher than multi-tenant retail strip because the risk is higher. When the night club building is foreclosed, it's much harder to sell or rent it compared to the multi-tenant retail strip. The rate for apartment is lower than shopping strip. To the lenders, everyone needs a roof over their head no matter what, so the rate is lower for apartments.

4. Age of the property: Loan for newer property will have lower rate than dilapidated one. To the lender the risk factor for older properties is higher, so the rate is higher.

5. Area: If the property is located in a growing area like Dallas suburbs, the rate would be lower than a similar property located in the rural declining area of Arkansas. This is another reason you should study demographic data of the area before you buy the property.

6. Your credit history: Similarly to residential loan, if you have good credit history, your rate is lower.

7. Loan amount: In residential mortgage, if you borrow less money, i.e. a conforming loan, your interest rate will be the lowest. When you borrow more money, i.e. a jumbo or super jumbo loan, your rate will be higher. In commercial mortgage, the reverse is true! If you borrow $200K loan your rate could be 8%. But if you borrow $3M, your rate could be only 4.5%! In a sense, it's like getting a lower price when you buy an item in large volume at Costco.

8. The lenders you apply the loan with. Each lender has its own rates. There could be a significant difference in the interest rates. Hard money lenders often have highest interest rates. So you should work with someone specialized on commercial loans to shop for the lowest rates.

9. Prepayment flexibility: If you want to have the flexibility to prepay the loan then you will have to pay a higher rate. If you agree to keep the loan for the term of the loan, then the rate is lower.

Commercial loans are exempt from various consumers' laws intended for residential loans. Some lenders use "360/365" rule in computing mortgage interest. With this rule, the interest rate is based on 360 days a year. However, the interest payment is based on 365 days in a year. In other words, you have to pay an extra 5 days (6 days on leap year) of interest per year. As a result, your actual interest payment is higher than the rate stated in the loan documents because the effective interest rate is higher.

Prepayment Penalty: In residential loan, prepayment penalty is often an option. If you don't want it, you pay higher rate. Most commercial loans have prepayment penalty. The prepayment penalty amount is reduced or stepped down every year. For example on a 5 year fixed rate loan, the prepayment penalty for the first year is 5% of the balance. It's reduced to 4% and then 3%, 2%, 1% for 2nd, 3rd, 4th and 5th year respectively. For conduit loans, the prepayment amount is huge as you have to pay for the interest between the note rate and the equivalent US Treasure rate for the whole loan balance for the remaining term of the loan. This prepayment penalty is called defeasance or yield maintenance.

Loan Fees: In residential mortgage, lenders may offer you a "no points, no costs" option if you pay a higher rate. Such an option is not available in commercial mortgage. You will have to pay between ½ to 1 point loan fee, appraisal cost, environment assessment report fee, and processing/underwriting fee. A lender normally issues to the borrower a Letter of Interest (LOI) if it is interested in lending you the money. The LOI states the loan amount, interest rate, loan term and fees. Once the borrower pays about $5000 for loan application fees for third party reports (appraisal, phase I, survey), the lender starts underwriting the loan. It orders its own appraisal using its own pre-approved MAI (Member of Appraisal Institute) appraisers. If the lender approves the loan and you do not accept it, then the lender keeps all the fees.

Loan Types: While there are various commercial loan types, most investors often encounter 3 main types of commercial loans:

1. Small Business Administration or SBA loan. This is a government guaranteed loan intended for owner-occupied properties. When you occupy 51% or more of the space in the building (gas station or hotel is considered an owner-occupied property), you are qualified for this program. The key benefit is you can borrow up to 90% of purchased price.

2. Portfolio loan. This is the type of commercial loans in which the lenders use their own money and keep on its balance sheet until maturity. Lenders are often more flexible because it's their money. For example East

West Bank, US Bank and some life insurance companies are portfolio lenders. These lenders require the borrowers to provide a personal guaranty for the payment of the loans. And thus these loans are recourse loans.

3. Conduit loan or CMBS (Commercial Mortgage-Backed Securities) loan. This was a very popular commercial loan program prior to the 2007 recession where its market size was over $225 Billion in 2007. It was down to just a few Billion in 2009 and is making a comeback with issuance of almost $100 Billion in 2015. Many individual loans of different sizes, at different locations are pooled together, rated from AAA to B and then sold to investors over the world as bonds. Therefore it's not possible to prepay the loan because it's already part of a bond. These are the characteristics of conduit loans:

   - The rate is often lower. It is often around 1.2% over the 5 or 10 year US Treasury rates compared to 1.85-3% over the 5 or 10 year US Treasury rates for portfolio loan. Some CMBS loans have interest only payments. Since the rate is lower and borrowers are required to pay interest only, the LTV can be over 75%. Low rates and high LTV are the key advantage of conduit loan.
   - Conduit lenders only consider big loan amount, e.g. at least $2M.
   - Lenders require borrower to form a single-asset entity, e.g. Limited Liability Company (LLC) to take title to the property. This is intended to shield the property from other the borrower's liabilities.
   - The loans are non-recourse which means the property is the only collateral for the loan and the borrowers do not have to sign personal guaranty. And so these loans are popular among investment firms, REIT (Real Estate Investment Trust), TIC (Tenants in Common) companies that invest in commercial real estate using funds pooled from various investors.
   - If the borrower later wants to sell the property before the loan matures, the new buyer must assume the loan as the seller cannot pay off the loan. This makes it harder to sell the property because the buyer needs to come up with a significant amount of cash for the difference between the purchase price and loan balance. Furthermore, the lender/loan servicer could reject the loan assumption application for various reasons as there are no strong incentives for it to do so. The loan servicer can also impose new conditions to loan assumption approval, e.g. increase reserve amount by several hundred thousand dollars. If you are a 1031-exchange buyer, you may want to think twice about buying a property with loan assumptions. Should the lender reject your loan assumption application, you may end up not qualifying for the 1031 exchange and be liable for paying capital gain. This is the hidden cost of conduit loan.
   - Even when you are allowed to prepay the loan, it costs an arm and a leg if you want to prepay the loan. The prepayment penalty is often called Defeasance or Yield Maintenance. Basically you have to pay the difference in interest between the note rate of your loan and the applicable US Treasury rate for the remaining years of the loan! This amount is often so high that the seller normally requires the buyer to assume the loan. You can compute the defeasance from www.defeasewithease.com website. Besides the defeasance, you also have to pay 1% loan assumption fee. This is another hidden cost of conduit loan.

   Conduit loan may be the loan for you if you intend to keep the loan for the life of the loan that you agree to at the beginning. Otherwise it could be very costly due to its payoff inflexibility.

Lenders Coverage Area: Commercial lenders would do business in areas they are familiar with or have local offices. For example East West Bank will only consider properties in California. Many commercial lenders don't lend to out-of-state investors.

Lenders Coverage Property Types: Most commercial lenders would only consider certain types of properties they are familiar with. For example Chase would do apartments and owner-occupied office buildings but not retail properties or gas stations. Westford Financial specializes on church financing. Comerica concentrates on owner-occupied properties.

Lenders Escrow Accounts: Most lenders require borrowers to pay 1/12 of property taxes each month. Some lenders require borrowers to have repairs and/or TI (Tenants Improvement) reserve account to make sure the borrowers have sufficient funds to cover major repairs or leasing expenses should existing tenants not renew the leases.

Conclusion: Commercial loans are a lot more complex and difficult to obtain with loan approvals more unpredictable than residential loans. As an investor, it is in your best interest to employ a professional commercial loan broker to assist with your commercial loan needs. By doing so, you will vastly improve your chances of paying lower interest rates, avoid potential pitfalls and improve your chance on getting the loan approved.