

## What Investors Should Know About Commercial Loans

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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. You provide to the lender with W2's and/or tax returns. In general the more income you make the higher loan amount you qualify. You could even borrow 100% of the purchase price if your income or stated income is strong. For commercial loan, the amount of loan the lender will approve is based on the rental income of the property, not your personal income. So the more rental income the property generates, i.e. the higher the CAP rate, the higher loan to value (LTV) the lender approves. If you buy a vacant commercial building, you will have difficult time getting a loan as it does not have any rental income unless you plan to occupy it for your business.

**Loan to Value:** Commercial lenders tend to be more conservative about the loan to value. Most commercial lenders loan up 75% of the value of the property. The following is just a rough guideline for LTV based on the CAP rate as the actual calculation is beyond the scope of this article.

CAP rate	LTV	Down payment
8% or more	75%	25%
7%	67%	33%
6%	55%	45%
5%	45%	55%

Lenders will only loan you the amount such that the income after expenses, i.e. net operating income is at least 20-25% more than the annual mortgage payment of the property. Or another words, the loan amount is such that you will have positive cash flow equal to at least 20-25% of the mortgage payment. So if you purchase a property with low CAP rate, you will need more down payment. This is so true for commercial properties in California as the CAP rate is in the 5% range. Commercial real estate is 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

- 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 you borrow \$2M, your rate could be only 6.25%! In a sense, it's like getting lower price when you buy an item in large volume at Costco.
- 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 lender, everyone needs a roof over their head no matter what so the rate is lower for apartment.
- 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.
- Area: if the property is located in a growing area like Atlanta metro the rate would be lower than a similar property located in the rural declining area of Arkansas. This is another you should study demographic data of the area before you buy the property.
- Your credit history: similarly to residential loan, if you have good credit history, your rate is lower.
- The lenders you apply the loan with. Each lender has its own rates. There could be significant difference, e.g. over 1%, in the interest rates. So you should work with someone specialized on commercial loans to shop for the lowest rates.

**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, 4-th and 5-th year respectively.

**Loan Fees:** In residential mortgage, lenders may offer you a "no points, no costs" option if you pay a higher rate. Such 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 all the fees, the lender starts underwriting the loan. If the lender approves the loan and you do not accept it then the lender keeps all the fees.

**Loan Types:** While there 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 is considered an owner-occupied property), you are qualified for this program. The key benefit is you can borrow up 90% of purchased price.

2. Portfolio loan. This is the type of commercial loans the lenders loan to you using their own money. Lenders are often more flexible because it's their money. For example United Commercial or Cathay Bank is a portfolio lender.
3. Conduit loan. It's harder to explain to an average consumer or investor what a conduit loan is. It's easier identifying it by its characteristics or just simply ask the lender.
  - o The rate is often lower. It is often around 1.25% 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. This is the key advantage of conduit loan.
  - o Conduit lenders only consider big loan amount, e.g. at least \$2M.
  - o 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.
  - o If the borrower later wants to sell the property before the lock out period expires, the new buyer must assume the loan as the seller can not 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 could reject the loan assumption application for various reasons as there are no incentives for it to do so. If you are a 1031-exchange buyer, you may want to think twice about buying a property in which you must assume the loan. Should the lender reject your loan assumption application, you may end up not qualifying for the 1031 exchange and have to send to Uncle Sam a big capital gain check. This is the hidden cost of conduit loan.
  - o 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 Yield Maintenance or Defeasance. Basically you have to pay the difference in interest between the note rate of your loan and the current 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](http://www.defeasewithease.com) website. Besides the defeasance, you also have to pay a hefty processing fee which is in the \$50-60K range! These are 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. For example while Green Point Commercial does business in Northern California, it does not cover Fresno or Sacramento County. United Commercial Bank will only consider properties in California. Provident Bank does business in Arizona, California and Nevada. Silver Hill Financial covers all 50 states but has a one million dollar loan limit. Kennedy Funding does business almost anywhere but the rate is pretty high as it is a hard-money lender. GE Commercial Financing will only consider transaction with at least \$5M loan.

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

Commercial loans are a lot more complex than residential loans. As an investor, you should employ a professional commercial loan broker to assist you with your commercial loan need. Chances are that you will end up paying lower interest rates, avoiding potential pitfalls and having a better chance to get the loan approved.