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It is important to do your homework before financing a commercial real estate property

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I recently had dinner with a college friend and he invited me to join his fantasy football league for the upcoming season. As an avid sports fan, I relished the opportunity to compete in this league and have fond memories of my success with fantasy football in my college years. For those of you not familiar with the topic, fantasy football has been played for over 20 years and provides fans with the opportunity to create their own roster of players by drafting talent from actual professional football teams.

The league begins with the draft that occurs approximately one week before the start of the National Football League (NFL) season. At this event, the prospective owners select their fantasy players. I decided not to "do any homework" for this draft since I figured that my sports knowledge would be sufficient to guide the way. However, the second I entered the draft, I knew that I was in for a long evening. Most owners had arrived at the draft thoroughly prepared, hours in advance and with several sports magazines in hand. The participants in the league were not the typical sports fanatics who spend a large portion of their day calling sports talk radio or watching ESPN. In fact, they were Wall Street professionals.

I guess if you want to own anything worthwhile in this country, it pays to "do your homework".

Many first time property owners fall into the same trap when they are seeking financing for a commercial real estate property. They can easily avoid pursuing deals that will never come to fruition by completing the following homework related to financing:

Know your "FICO" (credit) score.

"FICO" is the acronym for "Fair, Isaac and Company," the company whose computer system often referred to as "God" generates analytical models that can predict how a consumer will perform with their debt obligations in the future (based on their prior history). The FICO (credit) score is a computer generated number that predicts the measure of risk associated with extending an individual credit. FICO scores range from 350 to 850 points and a score of 700 or above is considered outstanding. Generally, in commercial real estate financing, a score of 700+ is considered Tier 1, a score of 660+ is Tier II and a score 620+ is Tier III. However, different lenders may have their own tier thresholds.

Know your down payment requirements.

100% financing of commercial real estate is about as common as a lunar eclipse. Don't be fooled by claims of creative 100% commercial financing which is becoming more and more prevalent in the residential property sector. There are low down payment (10%) programs offered by governmental agencies such as the Small Business Administration (SBA). However, they are primarily granted to individuals or entities that intend to occupy the subject property and are often referred to as owner-occupied commercial real estate. Credit for these types of transactions also tends to be structured around the financial solvency of the underlying business venture. The typical real estate transaction involving a commercial property solely for investment purposes (for example a non-owner occupied five-unit shopping center) requires between 20% to 30% down and don't forget closing cost of approximately 8%.

Know the Debt-Service Coverage Ratio (DSCR) requirements of Lenders

The DSCR is fairly simple to calculate and is an extremely beneficial calculation that provides the lender additional assurance that the debt obligation associated with the underlying commercial property will be satisfied. It is the amount of cash flow available to meet annual principal and interest (PI) payments on the debt obligation associated with the commercial property. Let's calculate the DSCR on a five unit shopping center with a purchase price of $2.5 million, loan amount of $1.75 million (30% down or 70% Loan-to-Value - LTV), 20 year term and a 7% interest rate. Each unit is occupied with a lease of $4,000 a month and all taxes, utilities and insurance are paid by the tenants. Therefore the gross annual rental income from this property is $240,000. If we assume a 5% vacancy factor and 10% for repairs/maintenance/other expenses the net income or cash flow available to meet annual PI payments would be $204,000 ($240,000 less $24,000 less $12,000). The annual PI payments would amount to approximately $163,000 resulting in a DSCR of 1.25 ($204,000 divided by $163,000). Overall, many lenders would be comfortable lending with a 1.25 DSCR because the borrower should have more than sufficient funds to make the annual PI payments.

As the DSCR gets lower than 1.25, the probability that the lender would consummate the transaction is reduced (a 700+ credit score and a low LTV could sooth the impact of a low DSCR). If the DSCR is less than one (negative cash flow), all bets are off because the borrower would need to utilize personal funds to remain current with the debt obligations. Generally, lenders frown on a negative cash flow.

We were constantly reminded to "do our homework" throughout our childhood and adolescent years; however, adhering to this mantra can be extremely beneficial in adulthood.

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