

## Increasing your Success Through Commercial Loans

By: Jeff Long, CPA

Throughout the last several Journal issues I have been exploring how you can earn big commissions by originating commercial loans. I would suggest that you review those articles and columns or contact me and I will send them to you. Before you can begin earning the big commissions, you need to understand the foundational concepts of commercial lending so meeting with clients will be most productive and profitable. One important fundamental of commercial lending is to know if your client's loan request is reasonable. Does it fit a lender's "Debt Service Coverage Ratio (DSCR)?" This may be a new term for you but, as you'll see, the concept of DSCR is logical and is closely related to a Debt-To-Income ratio for residential loans.

Since many borrowers will not understand what a DSCR is, you will need to be able to explain it. The DSCR is the ratio of the monthly Net Operating Income (NOI) to the monthly mortgage payment. The DSCR reveals the amount of **cushion** that a borrower has between the monthly mortgage payment and the monthly NOI. This statement is the key so let me state it again. \*\*\* The DSCR reveals the amount of cushion that a borrower has between the monthly mortgage payment and the monthly NOI.\*\*\*

To illustrate, if a borrower had a monthly NOI of \$1,000, would it make sense to make him a loan with a monthly mortgage payment of \$1,500? The answer is that of course it would not make sense. He would clearly be in the hole by \$500 with every payment. However, if the numbers were reversed and the monthly NOI was \$1,500 and the mortgage payment was \$1,000, then there would be a cushion of \$500 to fall back on if the NOI were to decrease. To calculate the DSCR using this example you simply divide the monthly NOI of \$1,500 by the monthly mortgage payment of \$1,000 to reveal a DSCR of 1.5. The key formula is Monthly NOI divided by the monthly payment equals the DSCR ( $NOI / Payment = DSCR$ ). The ideal underwriting standards for DSCR are above 1.35 but it can range from 1.0 to 2.0 depending on the property type, the borrower, and the lender. For our purposes, we should use a guideline of a 1.25 DSCR when screening deals.

A key component of DSCR is knowing what the monthly mortgage payment is going to be. To know this payment you must know the interest rate and amortization. Therefore, once you have provided Financial Resources with a loan summary or a loan package we will evaluate the loan, determine the interest rate and amortization, and ultimately calculate the DSCR. How can I use this DSCR information if I don't know the terms of the loan? Which comes first the chicken or the egg? Sorry! Which comes first, the terms or the DSCR? The answer is, you can estimate the terms to approximate payment amount and the DSCR for your client's deal. Commercial amortizations can range from 10-30 years, so you should use the most common and conservative amortization of 20 years. Commercial interest rates can range from 6 to 16%. To be conservative you should use a rate of 9%. Please note that these are only generalities and that there are plenty of exceptions to these terms. These terms are only meant to be guides. Please

don't misunderstand; all of our commercial loan terms are not for 20 years at 9%. This is just a benchmark. If you feel that your client's deal is above average, you can estimate the terms by increasing the amortization or reducing the interest rate. Conversely, if you feel the loan request is weaker than average your estimate can be based on a higher interest rate.

My next column will explore how property values are determined and some marketing ideas.

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