

Commercial Mortgage Underwriting

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Commercial vs. Residential

- Many similarities exist between Commercial and Residential Loans.
 - Property is used as security for the debt
 - Fixed Rate Terms
 - Adjustable Rate Terms
 - Commercial mortgages are sometimes structured as interest only loans

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Commercial Lending

- Commercial mortgages are not as standard as residential loans
 - Lenders/borrowers negotiate the terms of the loan since properties vary greatly
- Underwriting seeks to limit the probability of default
 - In the last 25 years defaults have occurred in 1 of every 6 commercial mortgages issued.

Differences

- Commercial loans usually have a shorter amortization period (20 years or less)
- Prepayments are often required using balloon provisions in the loan.
 - A balloon has an extended amortization term say 15 years but requires prepayment after 5 years.
 - Calculating a balloon is simply solving for the OMB

Other Differences

- Heavy prepayment penalties are often attached to commercial mortgages.
 - The amount of the penalty is sometimes determined by the spread between the contract rate and the current market rate for similar loans. (Yield Maintenance Fee)
- Lock-out provisions can also be implemented which forbid repayment of the mortgage prior to a certain time following origination.

Lender's Focus

- The borrower's creditworthiness is considered but receives less emphasis than the property itself.
- Decisions to lend on commercial properties typically center on property income.
 - Frequently borrowers are required to assign rents to the lender, securing an uninterrupted cash flow in the event of default



Borrower Considerations

- The borrower generally must provide personal or corporate financial statements
- The ability to pay debt service, should property income fall short, is considered
- Commercial mortgages are often non-recourse loans
 - This effectively creates a put option for the borrower (walk away).



Property Considerations

- When applying for a mortgage several items will need to be provided.
 - Pro forma estimates of income for the property over several years (often including historicals)
 - A market study of the properties broader and immediate submarkets.
 - An appraisal performed by an unbiased third party, hired by the lender



Market Study

- Market studies vary by property type
 - Apartment studies use population estimates
 - Office studies use employment growth
 - Retail studies look at personal income measures
- Generally a market study seeks to estimate the current and projected market conditions
- These studies usually measure the levels of Supply and Demand in the applicable market



Appraisal

- An appraisal is an estimate of the (market) value of the property
- Three methods are generally employed to estimate value
 - Income Approach
 - Sales Comparison Approach
 - Cost Approach
- The most applicable approach is given more weight in the estimate of value.



Assessing Risk

- Low loan to value ratios lower default loss
- LTV ratios are calculated as:

$$LTV = \frac{MB}{Value}$$
- Commercial LTV ratios are typically lower than residential LTV's.
 - Typical LTV's range from 70-80%
 - Some higher ratios are granted, up to 100%



Risk and Income

- Debt Coverage Ratios indicate how much excess (overall) income a property has relative to debt service.
- DCR's are calculated as:

$$DCR = \frac{NOI}{ADS}$$
- Typical DCR's range from 1.20 - 1.30



DCR and Mortgage Amount

- Given a lenders minimum DCR, what is the maximum amount that can be borrowed?
- Step 1:

$$DS_{\max} = \frac{NOI}{DCR_{\min}}$$

- Step 2:

$$MB_{\max} = \frac{DS_{\max}}{MC}$$



DCR Example

- Solve for the maximum loan amount:
 - The property net income is \$470,000. The mortgage terms given by the lender are 6.75% for 15 years. The lender requires a debt coverage ratio of 1.25 be maintained.

\$3,540,851

- If the lender allows a maximum LTV ratio of 80%, what can you pay for the property? (Assume your down payment is constrained)

\$3,540,851/0.80=\$4,426,065



Yield Maintenance Fee

- The lender can guarantee yield on a mortgage while allowing prepayment.
- Using an interest only loan we see:

$$YMF_n = \left(\frac{i_c - (i_{rf} + spread_0)}{12} \right) (MB_0) (PVAF_{i_c, n_p})$$

- $Spread_0$ =difference between i_c and the risk free rate at initiation, i_{rf} =rf rate at prepay.

YMF Example

- We have an interest only loan with an initial balance of \$5,000,000 which we wish to prepay. Our contract rate is 7% with a 20 year term. At initiation the 15 yr. risk free rate of interest was 5%. Today the rate for a five year Treasury is 3%. You wish to prepay after 15 years. What is the YMF?

\$420,850
