**Introduction to Commercial Property Financing assessment**

The most common three types of commercial property financing are **1) income-generating property financing** such as apartments, office, industrial and retails; This is usually the least risky among the three. **2) construction financing** - developers/builders build specific type(s) of properties and need financing over the duration of the construction and **3) land financing** - borrowers/builders apply for a loan to purchase a piece of land.

1. **Key Metrics:**

**Loan-to-Value (LTV):** loan amount/property value. The property value is usually evaluated by a professional certified commercial property appraiser who has extensive knowledge of the local market. Most of the banks/lenders have the maximum ratio for LTV for different property types. The higher the LTV, the risker of the loan for the lender.

**Net Operating income (NOI):** net income generated by a property after deducting [operating expenses](https://www.commercialrealestate.loans/commercial-real-estate-glossary/operational-expenditures). The NOI measures the ability of a property to generate income from operations. NOI = Gross income – operating expenses. Gross income includes rents, parking, laundry etc. Operating expenses include property tax, insurance, utility and maintenance etc. Please note NOI excludes the financing costs (principal and interest payment). NOI/cap rate = value of the subject property.

**Capitalization Rate (cap rate):** The rate lenders use to calculate the property value and usually regarded as the rate of return on an annual basis from the investment property. Everything else equals then the lower cap rate means higher property value. CBRE publishes the cap rates for major markets: <https://www.cbre.us/research-and-reports/North-America-Cap-Rate-Survey-H1-2019>

**Debt Service Coverage ratio (DSCR):**This ratio helps to determine the borrower’s ability to make debt service payments.  It is defined as the Net Operating Income (NOI) divided by Annual Debt Service on the proposed loan. The debt service is the total principal and interest payment of the loan on annual basis. A DSCR of 1X means the subject property produces just enough income to cover the loan payment. Hence the greater DSCR, the more flexibility it provides (more income than expense). Most of the lenders have lending threshold for different property types. For example: Apartment: 1.2X, Hotel: 1.5X, industrial: 1.35X etc.

**Property type:** Typical property types in commercial mortgages include: Multi-Residential (Apartment), Retail (shopping mall, strip mall, neighbourhood retail plaza), office, industrial (warehouse, for manufacturing/storage purpose) etc.

1. **Property assessment:**

* Location: population, crime rate, accessibility to local malls, highway, main streets, schools and hospitals etc.
* Vacancy rate: The vacant unit(s)/total rental units. The lower the rate, the better.
* Appraisal report
* Rent rolls
* Environmental assessment
* Building inspection + neighborhood inspection
* Property condition & age: Maintenance, repair and improvements.
* Tenant quality assessment: diversification the tenants, % of the top tenants’ rent to total rent amount; lease expiry date vs. loan term.
* Management experience

1. **Borrower risk assessment:**

* Relevant experience: borrower’s relevant experience in property construction, management or financing in the subject market.
* Financials: financial statements (cash flow, income and balance sheet) for borrowers and guarantors (when applicable) at least three years period. the financials examine the borrower’s financial position (income, free cash flow and net worth etc.) and credit worthiness (FICO score, late payment history and delinquency etc.).
* Compliance check
* Connection: Most of the lenders have a cap for the total exposure for one borrower and its subsidiary/affiliated companies. The cap can be a $ amount or % of the lending portfolio.

Please note some of the characteristics weight more than others in lenders’ assessment process. Other factors in assessment include the overall economy of the local market, government policy, local law etc.