

High Investment Returns – When is a Higher Interest Rate on Your Loan a Good Idea?

We are all taught from day one and we all learn the same lesson - when it comes to loans, the lower rate is always better. But that view is too simplistic and for that reason ultimately not accurate in all cases. There is one dividing line in this kind of thinking: Residential vs Commercial.

A **residential loan** made to a borrower for his or her primary residence will always be better with a lower rate. There is no exception assuming matching payment schedules. In this case, the source of repayment is produced independent of the property. A borrower goes to work everyday to make money so they can shell out the monthly payment on their mortgage. The borrower's income does not change relative to the size, type, or quality of house they buy. This is an instance where a higher or lower rate is given by a bank based on the stability of the borrower's income not the property's income. This means that a lower rate will ultimately require a lower monthly payment which is good because a borrower wants to keep as much of their monthly paycheck as possible. In addition, the income stream is generated by a person not a property. A lender will determine the loan amount available to a borrower based on their personal income after allocating the cost of other debt and living expenses. Other factors are considered, but this is the primary qualification consideration.

A **commercial loan** is made for investment purposes - and the determination of the interest rate is based on the bank's perception of that property's ability to repay its loan. The source of repayment is going to be the income produced by the property not by the borrower's personal income. The property produces income through tenants who will rent or lease a given amount of space. Different lenders put different weights of importance on each of these items according to their program's purpose: rehab project, passive income investment, etc. All lenders will evaluate the risk based on the following criteria:

Property:

- *Income Sustainability* - How likely is this income to remain stable over the course of the loan? Weekly or daily rents as with an RV Park or Hotel mean more volatility in income than the monthly or yearly rents typically collected on an Apartment or Mobile Home Park.
- *Value* - Are we lending the borrower more than a property is worth? If so, then there is not much to keep a borrower from walking away from the deal if things get tough or if the borrower wants to just pocket the proceeds of the purchase. A borrower with 20% down on an investment is much less likely to default than a borrower with 0% down. This is not just a logical conclusion, but a proven historical fact based on literally trillions of dollars of loans made and decades of tracking their performances. You can learn more about these kinds of stats from research companies such as Boxwood Means.

- *Economic Life* - Will the property still be in working order when the loan is due? If a 10 year loan is made on a property that will need substantial rehab in the next couple of years, a large risk to income is implied.
- *Economy* - Will the subject market continue to support the tenants with work so they can produce enough income to pay their rent? Economies largely relying on one particular company for employment such as a car manufacturer can run into trouble very quickly. Places like Detroit have run into this issue in 2007. This adversely affects the ability of tenants to pay their rent or even the desire to live in the market.

Borrower:

- *Borrower Income* - Are the borrower's personal finances upside down? If so, then it doesn't matter if the property has good cash-flow the borrower may still default because personal finances are a drain on the subject.
- *Borrower Credit* - How has the borrower repaid loans from other creditors in the past? This is still the same as in residential except commercial lenders have historically been more strict in criteria than residential lenders which have sub-prime credit programs.
- *Borrower Net Worth/Liquidity* - Is the borrower putting every last penny into the deal? If the property undergoes a fluctuation in income a borrower should have the ability to make payments while correcting the cash-flow issue or making necessary repairs or rehab.
- *Experience* - If things don't go as planned does the borrower know what it takes to keep the income flowing? Regardless of property or economic conditions many times an experienced borrower can overcome the obstacle and adapt to ensure the property remains full and income steady. This may involve different marketing methods or aesthetic property changes to attract new tenants.

We see that there is much more to consider in the decision of making a commercial loan. Now where does the high investment returns and their relation to interest rates come into play? **"With great risk comes great reward."** We'll take an example of two apartment complexes in the same neighborhood of similar size and property quality. We'll call the first property Tranquil Meadow Apartments and the second property Super Saver Apartments. Tranquil Meadow meets all the typical requirements for a conventional commercial loan. Super Saver is exactly the same property except that the renters are HUD Tenants whose rent is subsidized (If unfamiliar with this great government program you can visit the HUD Website listed below). Fear not, lenders are not discriminating against low income housing. They are making very simple and logical risk decisions. This HUD property contains more risk because it takes a highly skilled borrower to run it correctly. Contracts are executed with the government agency and the borrower must keep in compliance with HUD regulations. If the property owner does not continue to keep the property in compliance, then the subsidies can go away very quickly and leave the borrower with a property producing almost no income. So Super Saver deserves a higher rate as the loan made on it is in higher risk of default. To offset this detriment in risk there is the higher expected investor return because HUD properties typically pay higher than market rent.

Super Saver, \$1,125,000 Loan at 7% and 30 year amortization with \$375,000 Down:

33 Units with average rent of \$550/month.

33 X \$550 = \$18,150/month

-\$8,150/month in expenses =

\$10,000 Net Operating Income (The income left after normal operating expenses are deducted)

-\$7,496.13 Monthly Loan Payments

= \$2,503.87 Positive Cash-Flow

Tranquil Meadow, \$1,125,000 Loan at 6% and 30 year amortization with \$375,000 Down:

33 Units with average rent of \$520/month.

33 X \$520 = \$17,160/month

-\$8,150 in expenses (note the exact same number for both properties) =

\$9,010 Net Operating Income

-\$6,758.88 Annual Loan Payments

= \$2,251.12 Positive Cash-Flow

We can see clearly that even though the rent difference is only \$30/month per unit it is more than enough to make up for the 1% difference in interest rate. Sometimes the variance between subsidized rents and market rents is \$100 or more a month per unit. The annual return on investments from a cash-flow stand point for both properties in our example are as follows:

Super Saver:

$\$30,046.44 \div \$375,000 = 8.012\%$ ROI

Tranquil Meadow:

$\$27,013.44 \div \$375,000 = 7.204\%$ ROI

From our very conservative example, the difference is about \$3,000 or about eight tenths of a percent better per year in return. As mentioned, many times these returns can be

increased much more than in our arbitrary story. These higher returns are made possible by higher interest rate loans for properties with inherently higher risk factors. So next time your lender quotes a rate higher than you would get on your home, stop and think about the big picture. Investigate the bottom line for those slightly higher risk properties if it is in line with your own investment risk tolerance and reap the rewards.

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