

LESSON FIFTEEN
HOW DOES ONE FINANCE SMALL INVESTMENT PROPERTIES?

I. SINGLE-FAMILY DWELLINGS (SFD) AS INVESTMENTS

A. What are Some General Characteristics of SFD Rentals?

B. What kinds of Financing are available for SFDs?

1. Conventional loans of 70% of appraised value.
2. Lenders generally require at least 20% down and do allow secondary financing for the balance of the purchase price.
3. Assumption of existing loan, with seller carrying back second loan.
4. Care should be taken to insure that the loan is one that can be assumed and by whom – an owner-occupant or a non-owner occupant.

C. Interest Rate and Other Terms of Loan for Rental Homes

1. Conventional lenders generally ask for ¼% to ½% more interest on a rental home than on an owner-occupied single family residence.
2. Single-family homes almost always command the lowest interest rate and the best overall terms.
3. Terms of the loan, late charges and other provisions are generally the same as for owner-occupied, single family homes.

III. LARGER-SIZED APARTMENT PROPERTIES.

A. General Characteristics

B. What Kind of Financing is Available?

1. Most apartment houses are financed by conventional loans of from 70% to 80% of value. The ratio is reduced from 80% to 70% with larger complexes.
2. Interest rates can range from 1/2% to 1 ½% higher than for prime single dwelling. Loan fees range from ½% to 1% higher than with single units.
3. Term of the loan may be 30 years, but is usually 25 years on larger complexes.
4. Lenders are generally more concerned about credit of the borrower.
5. Regardless of sales price, the lender makes their own evaluation of the property. If present rents are not supportable, they may use average market rents for similar units in the area.
6. For furnished apartments, lenders deduct rental income attributable to the furniture and use capitalized income stream from unfurnished units to determine market value.
7. When conventional loans are not available, one or more of the creative financing techniques covered in Lesson 14 might be used, sometimes on an interim basis only, until conventional financing is again available.
8. Thrift institutes are viable as a source of financing of large apartment projects, but losing ground to commercial banks, life insurance companies and pension funds.

IV. MARKETING APARTMENT PROPERTIES: THE BROKER'S ROLE

A. What Motivates Owners to Sell Their Apartments?

B. What Financing Information Will I Need to Obtain?

1. Get name of lenders, address, phone number and loan number. Get written authorization from the property owner(s) to write the lender in order to obtain such vital information as status of existing financing, terms of the note, current unpaid loan balance, pay-off provisions and assumability, etc.

2. If more than one loan, obtain the same information for each lender. Ascertain whether any of the lenders will permit financing through an AITD or other creative instruments.
3. Ask the owner(s) for a copy of each note and trust deed for each loan. If they do not have a copy, obtain written authorization for you to obtain from the lender.
4. Check each note for the monthly payment, interest rate, due dates, prepayment provisions, due-on-sale and acceleration clauses, along with any other information that will help you determine appropriate financing options.
5. Determine whether the loan is held by an institutional investor or by a private party.

V. NON-RESIDENTIAL RENTAL PROPERTIES.

A. Commercial Properties.

B. Industrial Properties

C. What are some Advantages of Investing in Commercial and Industrial Properties?

1. May require less management than residential rentals.
2. Cost-of-living clauses, or, in the case of a retail establishment, a percentage lease provision allows the owner to realize increased rents.
3. City growth creates greater demand for commercial properties, offering opportunities for increased rents.
4. There is little risk of rent control.

D. What are some Disadvantages of Investing in Commercial and Industrial Properties?

1. Investment in older commercial buildings, such as found in urban centers, involve greater risks as tenants move to newer centers, with vacancies taking longer to fill. Subsequent tenants may be of lower quality and not be able to pay as high a rent.
2. Changing neighborhood patterns may result in an entire commercial area becoming less desirable. In many downtown areas, blights and decay give rise to urban flight.
3. Tenants may have long-term leases at advantageous rents, thereby freezing owners into low fixed revenues while taxes and other operating expenses rise.
4. City requirements often force owners to add expensive improvement to assure safety of occupants.
5. Commercial banks often will not lend on older commercial or industrial properties unless the investor is a major client of the bank. Most thrift institutions shy away from such properties.

VI. FINANCIAL RATIOS.

1. Loan-to-Value Ratio. Loan amount divided by the project value. (If the building is not yet in place, then the projected value is based on the projected cash flows. Performance statements need to be prepared in these cases.
2. Debt Coverage Ratio. Divide the Net Operating Income (NOI) by the debt service (Monthly loan payment).
3. Operating Expense Ratio. Divide the operating expenses by the effective gross income.
4. Break-even Ratio. Add the operating expenses, plus the debt service together, then divide by the potential gross income

5. Internal Rate of Return (IRR). Applications to before- and after-tax yields on compounding basis.
6. Present Value (PV) and Future Value (FV). Useful in many ways, but concentrate on sale-lease back arrangements and other forms of real estate investments.
7. Loan Constants. Useful in computing cash flows is significant here.