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Alternatives to commercial real estate: A buyers/ borrowers strategy should be adjusted accordingly

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On April 6, 1973, Major League Baseball introduced the Designated Hitter (DH) rule to regular-season play when Ron Blomberg of the Yankees stepped up to the plate against Luis Tiant of the Red Sox.

MLB is divided into two leagues; the National League and the American League; however, the DH rule was only instituted in the American League. This difference has probably set off the biggest debate in baseball history and statistical gurus have written extensively on the DH and distinguished economists have published research papers on the topic. The introduction of the DH rule dramatically changed the overall strategy in baseball and I often ponder how two leagues that are part of the same organization exist with significantly different rules.

There is a comparable deviation in the world of real estate between the underwriting and compliance rules for investment properties considered to be residential real estate and investment properties that are considered to be commercial real estate. A buyer's overall strategy needs to be adjusted accordingly.

Residential properties are defined as structures designed for the occupancy of one to four families. Commercial properties provide occupancy for more than four families, for a business or a combination of the two. Buyers often have a misconception that two to four family homes held for investment purpose are considered commercial properties and this can lead to financing complications.

Major Compliance Differences

Financing required for residential properties is considered a "federally related mortgage loan" and therefore is governed by Title 24 of the Code of Federal Regulation. In particular, Part 3500 - Real Estate Settlement Procedures Act (RESPA) as well as the applicable State laws. The purchase of residential real estate held as an investment is governed by the same laws and related procedures as if you were buying a primary residence. These regulations require completion of the standard application, disclosures of fees earned by the banker/broker, a good faith estimate detailing closing costs and various supporting documentation from the borrower. On the other hand, financing related to commercial real estate is not governed by any federal or state statutes so the buyer should beware.

Underwriting Differences

Since most mortgage bankers are rarely residential property portfolio lenders, they usually sell residential loans in the secondary market to Fannie Mae, a government sponsored enterprise or other investors. The underwriting guidelines for residential property loans are more structured and stringent as compared to their commercial property counterpart which is more subjective. The lender requires a higher down payment on a commercial property financing due to this subjectivity as well as other factors.

A major difference in underwriting between investment properties considered to be residential real estate and investment properties that are considered to be commercial real estate, is the calculation or methodology which provides the lender assurance that the debt obligation will be satisfied. Obviously, the borrower's credit score will provide additional assurance.

Residential property financing is subject to the borrower's overall Debt to Income Ratio (DTIR). The DTIR calculation takes into consideration the relationship between a borrower's monthly debt obligations and monthly income from all sources. Typically, the DTIR for approved financing ranges between 40% and 50%. For example, assume that the borrower earns $9,700 a month and has approximately $4,000 in monthly debt obligations including mortgage payments, car payments and credit card payments. Let's also assume that the subject property, a three family structure generates approximately $300 in monthly net income. This would result on a DTIR of 40% ($4,000 divided by $10,000).

Commercial property financing is subject to the Debt Service Coverage Ratio (DSCR) of the subject property. It is the amount of net cash flow generated from the commercial property leases available to meet annual principal and interest (PI) payments on the debt obligation (cash flow divided by PI). Overall, many lenders would be comfortable lending with a 1.25 DSCR because the borrower should have more than sufficient funds to make the annual PI payments. As the DSCR gets lower than 1.25, the probability that the lender would consummate the transaction is reduced.

Residential properties held for investment purposes can be worthwhile and lucrative alternatives to commercial real estate but the underwriting and compliance guidelines are substantially different. Therefore, buyers/borrowers should adjust their overall strategy accordingly.

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