CRE “By the Numbers”: Lender Metrics

Let’s explore two metrics commonly used by commercial lenders when they consider financing property debt: Debt Service Coverage Ratio (DSCR) and Loan-to-Value (LTV).

DSCR in a Nutshell

One of the first things lenders want to know for any deal is whether the property makes enough in income to cover mortgage repayments, i.e., what is the maximum loan value the property can support? DSCR tells them just that by comparing a property’s Net Operating Income (NOI) to its annual debt service (the total annual mortgage payment that would be due on the property).

The formula for DSCR is therefore:

$$\text{Debt Service Cover Ratio (DSCR)} = \frac{\text{Net Operating Income}}{\text{Total Debt Service}}$$

Generally, lenders are looking for a DSCR ratio of at least 1.20-1.25 or higher. For example, on a property with a debt service of $200,000, a lender would want to see NOI of $240,000 or more, because in this case:

DSCR = 240,000/200,000 = 1.20.

It’s worth noting that this is very much a guideline value. During periods of greater economic risk, or for properties where income flow is riskier, lenders may set a higher minimum DSCR to safeguard against later defaults.

CRE “By the Numbers”: Lender Metrics

Measuring Risk

How much a lender is prepared to offer depends on property type and perceived market risk. In addition, the greater the proportion of debt that’s required to finance a property, the riskier the lender considers the loan.

Lenders will therefore set a maximum Loan-to-Value or LTV ratio that they’re comfortable supporting for a specific property or property type. The formula for LTV is:

$$\text{Loan to Value (LTV)} = \frac{\text{Loan Amount}}{\text{Property Value}}$$

So, if a property is valued at $150,000 and requires a loan of $120,000, the LTV value would be: 120,000/150,000 = 0.8 or 80%.

As with DSCR, lender LTV requirements tend to be stricter during periods of economic uncertainty, or as a result of any additional sources of risk in the deal. In other words, faced with risk, they’ll provide a lower percentage of the financing costs, and the borrower will need to invest more of their own equity.

For stabilized assets, a general LTV of around 70-75% is often considered acceptable by lenders, while the rate for riskier assets could slide considerably lower.

Determining Value

As with other CRE metrics, the exact values a lender is prepared to work with will vary by deal, location, and property type, as well as in response to prevailing market conditions.

What’s important for investors, and CRE professionals, to remember is that these numbers form pieces in a larger and more complex puzzle. Assessing a property’s true value requires familiarity with the market, a keen eye, and a focus on the fundamentals supporting that value.