Common Terms and Ratios

There are a number of common terms and ratios that are part of the commercial mortgage process. The most common are explained below:

Loan-To-Value (LTV)

This is the percentage of the property's purchase price or value (most lenders use the lower of the two) that the lender is willing to lend.

Loan Amount / Value =LTV (Example: $1M loan amt/$1.25M purchase price= 80% LTV)

Combined Loan-to-Value (CLTV)

This percentage is calculated the same way that LTV is, but it takes into consideration all loans against the property and not just the loan being acquired (i.e. if the seller holds a 2nd mortgage on the property or there are any other liens against the property.)

Example: $800k loan amt+ $200k seller held 2nd/$1.25M purchase price= 80% CLTV)

Potential Gross Income (PGI)

The maximum rental income from 100% occupancy.

Effective Gross Income (EGI)

This equals gross income less vacancy and credit losses.

Net Operating Income (NOI)

The income remaining after all direct operating expenses and vacancy/credit loss are accounted for. Only direct operating expenses specific to the property are used. Capital expenses are not included. Loan payments (debt service) are not included in the NOI either.

This is what a sample operating income statement might look like:

$150,000 Potential Gross Income (PGI)
- $ 7,500 Vacancy & Credit Loss (5%)*
$142,500 Effective Gross Income (EGI)
$ 7,125 Management Fee (5%)*
$ 2,850 Replacement Reserves (2%)*
$ 10,000 Taxes
$ 4,000 Insurance
$ 8,525 Utilities
- $ 10,000 Repairs and Maintenance
$100,000 Net Operating Income (NOI)

*Vacancy &Credit Loss, Management Fee, and Replacement Reserves are expenses that may not be actual costs of the subject property, but they are expenses that a lender will take into consideration when underwriting a transaction.

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Management Expense: Even if the property is self-managed, a lender will underwrite the property based on what it would cost them to operate it and will include a management fee (often 5%).

Vacancy & Collection Loss: Even though a property may be fully leased at time of application, move-outs or evictions inevitably occur. Some factor must be applied to get a realistic view of the property's ability to service debt in normal conditions. The lender will apply a standard vacancy & credit loss, usually around 5%. However, if the appraisal indicates a higher percentage in the market area, the percentage may be increased.

Replacement Reserves: This is a reserve account that is to go towards estimated future capital expenses (i.e. new roof, new air conditioner, etc.) A lender may or may not collect the reserves, but it is usually counted as an operating expense whether it is collected or not. The amount may be calculated: as a percentage of EGI, based on square footage, or an actual estimate of the useful life of the items. The method used depends on the specific lender's underwriting requirements.

Capitalization Rate (Cap Rate)

This is the discount rate used to determine the present value of a stream of future earnings. It is represented as a percentage that relates the value of an income-producing property to its future income and can be calculated by dividing the NOI by the purchase price or value. In simple terms, this is the one year rate of return on the property if the property was paid for in cash with no financing. The Cap Rate applied to a particular property is dictated by the market that the property is located in.

NOI/Cap Rate= Value
NOI/Value=Cap Rate
Value x Cap Rate=NOI

Debt Service

This is the total of a property's principal and interest payments on a monthly or annual basis.

Debt Service Coverage Ratio (DSCR)

The DSCR is a ratio used to analyze the amount of debt that can be supported by the cash flow generated from the property. Or, simply the net income generated by the property divided by the new loan payment.

NOI / Payment=DSCR

(Example: Annual Debt Service= $60k and NOI=$75k $75/$60k=1.25 DSCR or 125% of the debt payments.)
Most lenders usually require a 1.10-1.25 DSCR ratio.

Debt-To-Income Ratio (DTI)

This equals total monthly debt payments divided by total personal monthly income. This calculation is primarily used in residential loans, but there are times when a commercial lender will take your personal income into account and use this ratio.

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