RESIDENTIAL LOANS VERSUS COMMERCIAL LENDING...

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"Probably the most common topic we discuss with new investors is the difference between residential lending versus commercial lending. Both asset classes are qualified and structured very differently, so it's important to understand those differences on a high level. Residential lending standards are considered to finance properties that are 1-4 units residential. However, any multifamily residential property over 5 units - commercial lending requirements are used."

WHAT ARE THE HIGH LEVEL DIFFERENCES BETWEEN RESIDENTIAL VS. COMMERCIAL?

01 **LENDERS.** Residential loans are financed most frequently by Fannie Mae, Freddie Mac, and larger banks for jumbo investment property loans. Commercial loans have a wider variety of potential lending sources for you to compare if you have access, including agency lenders, banks, credit unions, life companies, debt funds, CMBS conduits and crowdfunding sources.

02 **LOAN STRUCTURE.** While residential loans are typically 15, 20 or 30-year fixed fully amortized loans, commercial loans are hybrid loans. Commercial loans will usually have a 30-year term and amortization, but the rate will only be fixed for the first 5, 7 or 10 years. After the fixed period, the rate goes to an adjustable rate. You will want to understand adjustment terminology and total interest comparison methods.

03 **DOWN PAYMENT.** Residential properties can achieve a 25% down payment consistently for qualified borrowers. Commercial down payments are going to be case-by-case per property since it's determined by two property factors – risk and cash flow. The worse the property net income, the higher required down payment – despite how strong or high salary the borrower is. The property needs to stand on its own. Average commercial down payment is 35% down as of 2022 and expected to inch closer to 40% down in 2023 in a higher interest rate environment. Having the resources and experience to provide an adjusted NOI analysis proposal can help here.

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04 **INTEREST RATES.** Commercial interest rates are going to be roughly comparable to residential rates. Commercial rates as you've learned however are going to be fixed for a shorter period of time - 5, 7 or 10 years fixed as opposed to 30 years fixed. There are also other factors to consider including interest only periods and ability to pay down rate. See our interest rates white paper for what qualification factors and investor-controlled loan terms move the needle the most.

05 **BORROWER QUALIFICATION.** A common misconception is that borrower strength is not a factor with commercial properties. While its true that the property determines down payment and primary terms, commercial lenders are still going to have guidelines for liquidity reserves, minimum net worth, credit, and investment property experience. Some commercial lenders might not require tax returns or perform global cash flow (DTI equivalent), but this is not across the board and may not be available for your request.

06 **PROPERTY QUALIFICATION.** The property's in-place cash flow determines mostly everything. Its NOI directly determines the maximum loan amount and required down payment. Stronger cash flow also determines the loan conditions available or imposed. Besides cash flow, a checklist of other items are also evaluated including market & neighborhood, quality & condition, vacancy, historical operations, performance risk and lease structures.

07 **PRE-APPROVAL.** While residential lenders can pre-qualify or pre-approve you before writing an offer based on your personal financials, commercial loans cannot be approved until the end of due diligence process. You will however receive a "Letter of Interest (LOI)" from the lender with proposed terms and general requirements. While commercial lenders do not intend to mislead any parties involved, LOI issuance does not have standardized procedures. The level of pre-screening varies lender to lender, and loan officer to another. Having a solid understanding of pre-screening or an experienced mortgage broker is very important here.

08 **REPORTS REQUIRED.** Like residential loans, commercial loans will also require a property appraisal report. However, in addition – depending on the lender and property size, additional reports such as environmental reports, engineering/structural reports or earthquake risk reports may also be required. Some lenders are more report heavy than others, and should be considered in your overall loan costs.

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09 **VESTING.** Commercial lenders do not have many restrictions on this topic, and will lend individuals, trusts, LLCs, and corporations. Residential lenders on the other hand are notorious for not typically allowing entity ownership with their loans. Commercial lenders do allow this vesting structure, and sometime even require an LLC vesting with the subject property being the single asset (single asset entity).

10 **RECOURSE.** While residential loans are always “non-recourse” meaning that there is no personal liability attached to these loans, it’s more of a gray area with commercial. Depending on the loan size, lender type and LTV – recourse or personal guaranty may be required of the sponsors. Non-recourse loans are available but will have “bad boy carve outs” which are rare exceptions which trigger liability.

11 **PREPAY PENALTIES.** Investors familiar with residential loans will not be used to prepayment penalties. Prepay penalties are common in commercial loans and impose a penalty fee on the investor should they sell or refinance before certain dates. Prepay penalty structures come in many shapes and forms, but the main ones to understand are stepdown structures, yield maintenance and defeasance. No penalty loans do exist but are less available and usually at a rate premium. Caveats can be negotiated including an annual paydown allowance (say 20%), and internal refinance waivers.

12 **LIMITATIONS.** Residential lenders like Fannie Mae and Freddie Mac are going to have a maximum number of loans you are allowed to have on the books. Commercial lenders are not going to have this issue. Since the lending sources are more abundant, you can spread your loans across different lenders when needed. You are also not going to be limited or penalized for larger loan amounts as you grow as an investor, commercial lenders are setup to handle larger loan amounts and capacity and welcome growing investors.

13 **TIME FRAMES.** Probably the most common issue we run into with new commercial purchases is expected time frames. Buyers familiar with residential loans entering an escrow typically reach from experience and write 30-day escrows. While short-term bridge loans can accommodate if needed, most conventional lenders are going to need 45-60 days on average, and sometimes up to 90 days for less competitive lenders to close the loan. Some processes can be expedited, but it’s important to understand your preferred lender’s time frame, seller expectations & flexibility, and average appraisal bids – and have each coincide with each other when selecting your financing.

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14 **LOAN COSTS.** Commercial loan costs are on average going to be, or at least appear, higher than residential costs. Commercial lenders do not "build costs into the interest rate", and instead charge all fees separately as a dollar cost. Property reports (appraisal, etc.) are going to be more complex and expensive, loan points not financed into the rate, and miscellaneous fees (processing, loan docs, lender legal) can vary depending on the size and complexity of the property.

15 **FEE DISCLOSURES.** Residential 1–4-unit lending is more regulated than commercial lending. While commercial is not the wild west, there is much less restriction or expectations here. Commercial lenders, mortgage brokers and escrow involved in the process, will in good faith do their best to set accurate expectations on fees for clients – but are not required to follow any specific procedures or time frames. It is not uncommon for legal fees to increase for loans that become more involved, appraisal bids to come back higher than expected, or lenders to increase point fees if undisclosed borrower risk is uncovered during due diligence.

HARBORWEST is very experienced working with new commercial investors to help them better understand the often times complex process, nuances, risks and rewards of commercial real estate financing.

If you are expecting to be involved with a nationwide multifamily commercial (5+ units) transaction with a loan amount need above $1,000,000 (so, let's say a benchmark of $1,500,000 purchase price) - we can add a lot of value to your loan terms and your overall experience. Contact our team to schedule a call, and we'll get you setup properly.

Should you be interested in multifamily (5+ units) financing, but your investment property won't quite make our $1,000,000 loan minimum - we still got you covered. California loan minimum start at $500,000 for our team. Below $500,000 we can at least provide a few great referrals and a lender list from recent market transactions below $500,000.

Let's chat. We look forward to working with you!

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HARBORWEST is a nationwide commercial mortgage brokerage and advisory company. Our team specializes in providing commercial real estate financing strategy and solutions for high net worth California investors, developers and business owners.

We are proud to be #1 rated in our industry by **GOOGLE BUSINESS** for 2021, 2022 and 2023. Explore client reviews for insight into proven results with our team (*120+ reviews*).

LET'S CHAT.
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