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By Kent Cooper, CCIM

The fundamentals of commercial income properties have changed drastically over the course of the last several years. The good news is; we no longer have to pull a Cap Rate out of thin air. It no longer matters what the price of the property is or how much down payment someone wants to put down.
The banks don't care what the cap rate is, nor do they care how much someone wants to buy or sell a property for. They don't even care how much someone wants to put down on a property. All they care about is the debt service coverage and that they have the first lien on the property. They also want to know that the Buyer has a golden credit rating.

The new world of lending on commercial income producing properties works like this:
I recently listed a small 15-unit retail strip center. Nothing fancy, but it stays fully leased up. Rents are between $10 and $12 per SF. When the owner loses a tenant, which is rare, he puts a sign out on the roadway and within a few days he has a new tenant. Here are some numbers to work with:

Gross Potential Income	$216,519
Vacancy & Collection	5%
Effective Gross Income	$205,693
Expenses	
RE Taxes	$ 20,571
Insurance	$ 4,800
Management	$ 6,168
Repairs & Maintenance	$ 4,542
Utilities	$ 8,400
Miscellaneous	$ 2,055
Total Expenses	$ 46,536
Net Operating Income	$159,157

Where would you price this investment? If you look at all the properties on Loop Net you might say that cap rates for a purchase like this are around 7% to 7.5%. That would put the selling price of this property somewhere between $2.1 mil and $2.2 mil. In fact, that's what the Seller wants to sell it for.

Here's the rub. The banks want a 1.35% debt service coverage ratio. That makes pricing the center very easy. If you have an NOI of $159,157, that means you have that amount to make debt service with. That amount has to equal 1.35 times your payment.

Lets say you write up a contract for $2.2 million to buy this property. How much would you have to put down to make the debt service coverage? Let's say that you have found a bank that is still in business. Better yet, you have found a bank that is willing to lend money. Let's say your Buyer has a golden credit rating and the bank will lend as much money as possible; with a 1.35 debt service coverage ratio for 20 years @ 7.0% interest, with monthly payments.

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Using the old HP-12C (or, better yet, the CCIM DCF Analysis), it's easy to see that the maximum payment available is $117,894 ($117,894 X 1.35 = $159,157 NOI). That means the maximum amount of money the bank is willing to lend on this property is $1,267,188.

OH NO, you wrote the contract for $2.2 mil. That means your buyer has to come up with a whopping down payment of $932,812 (42%) plus acquisitions costs ($22,000) and loan costs ($25,344), for a total of $980,156. Guess what; the Buyer gets a cash on cash return, after debt service of $41,263 or a first year cash on cash return of 4.2%. The after tax return would be around 3.1%.

Lets say the Buyer comes back with a NO WAY, JOSE. He wants to get at least a 6% cash on cash return in his first year. That means the price of the property has to be lowered to around $1.9 mil.
Lets look at the Cap Rates. You initially wrote the contract at $2.2 mil or a Cap Rate of 7.23%. In order to get a deal, your Buyer says he will only pay $1.9 mil or a Cap Rate of 8.37%, in order to get his cash on cash return.

Now look at Loop Net and try and find commercial income properties that are fully stabilized for sale with a Cap Rate of 8.37% or better. They are out there. The properties that are being advertised with a 6% or 7% Cap Rate are just taking up wasted space. Worse than that, when a Broker like me goes to talk straight with a prospective Seller, I get blown out of the water because the Broker down the street agrees to list the property at one of these ridiculous prices. It's time that commercial real estate brokers start educating their clients or they may never have another sale. Worse yet, neither will I.

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