NETWORKING TODAY

Financing Commercial Properties

By Bruce Smith

First time buyers of businesses, commercial properties, and income producing properties often hear about the competitive residential mortgage market, where buyers can purchase homes for no money down or at rates below prime. However, commercial properties are not subject to the same rules.

Are you buying assets or shares?

Typically, when you purchase a business you are purchasing the entire company (shares of the business), or the assets of the business (building, equipment, inventory, name, goodwill, etc.). It is important to understand this distinction.

Sellers want to sell shares for the tax advantages and because all liabilities associated with the business will transfer to the buyer. On the other hand, buyers like to buy assets to avoid assuming unforeseen liabilities and to make financing easier.

Lenders look for security in hard assets, such as buildings or equipment – things they can take repossession of and re-sell if required. You may have to find multiple lending sources to secure the necessary financing. The lender, which holds the commercial mortgage on the building may have no interest in lending against other assets and may have less interest in soft assets, such as goodwill or working capital.

When is a commercial property not a commercial property?

If you purchase an income producing residential property of four units or less, it may be possible to make the purchase using typical residential mortgage conditions. Each lender has specific eligibility conditions so it's best to have a mortgage broker review your options.

Conversely, a single family home may require commercial property financing if a zoning variance has been granted to allow special business use (such as a hair salon) for home operation. Homes containing traditional home based businesses that meet the conditions of local municipal by-laws and have not sought a zoning variance can continue to be financed as residential.

Credit considerations

If you're buying commercial property through your own existing company, both your company's credit and your personal credit will be checked to determine eligibility. Plus, your creditability as a landlord or business owner will be reviewed, evaluating your experience and success in managing current and past businesses – creating a borrower profile.

Income considerations

Lenders like to examine financial statements from the previous owners to determine revenue and expenses associated with a commercial property. It should be evident that sufficient income exists to service the new debt.

If you are taking over the property for a new use, for example, you are moving your business into the space; lenders will review your previous financial statements and future business projections to determine if your business earns sufficient income to service the debt. If you plan on leasing the property to existing tenants, then current lease agreements will be required.

Loan to value

Often the biggest hurdle in financing a commercial property is the maximum loan to value (LTV) or the loan you can receive in relationship to the value of the property. The maximum LTV allowed is determined by your credit history and the type of property you're financing.

Properties with a residential component do best (85% for apartment buildings), while properties with environmental concerns (manufacturing, gas stations) or businesses with poor success rates (restaurants) typically LTV much lower.

The good news is that when establishing the value of a commercial property, lenders often value beyond the bricks and mortar of the property. Lenders give consideration to the cash flow generated from a property as part of the total valuation.

The bad news is that this form of commercial property appraisal is expensive when compared to a residential appraisal. Given the lower LTV ratio for commercial properties, vendor take back (VTB) financing is often used in conjunction with traditional lender financing.

In an effort to assist in the sale of a property or business, existing owners are often asked to finance in a subordinate position to other lenders. There are no concrete rules behind such lending so terms, interest rates, and conditions vary greatly from deal to deal.

Geographical considerations/environmental assessment

Lenders prefer urban areas to rural areas. Expect some form of environmental review as part of the lender's due diligence. Properties with possible exposure to contaminants would be subject to additional review.

Interest rates

Interest rates are calculated from the net effect of everything mentioned including credit, income, and loan to value. Commercial rates are traditionally higher than residential rates due to the added risk associated with business failures, potentially long vacancies, and the inability to quickly resell the property in the event of foreclosure. The size and quality of the deal will also influence rate, as premium deals attract more lenders and lower rates result.

It is always wise to contact a mortgage broker that deals in commercial mortgages to review your documentation, package your deal, shop the market, and arrange the best financing for you based on your unique circumstances._

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