Integrity Loan Review LLC

Underwriting with a Debt Yield Metric

Background

Over the last few years, I have observed more frequent use of a debt yield calculation as a part of commercial real estate (CRE) underwriting. The reason is due to the simplicity of the debt yield formula and its higher degree of consistency when compared to alternative underwriting metrics such as loan to value (LTV) and debt service coverage ratio (DSCR). Even so, I have not observed the addition of a debt yield metric to the CRE lending policies of community-based financial institutions (CBFIs).

So, what's the big deal? My curiosity as to how a debt yield metric could add value to CBFI commercial real estate underwriting led me to create the example below. The example identifies and highlights the differences when applying the LTV and DSCR metrics in the underwriting of a credit opportunity as compared to a debt yield metric.

Comparison of Debt Yield to DSCR and LTV

Incorporating actual information from a recent self-storage property appraisal, I have utilized the net operating income (NOI), the capitalization rate (Cap Rate), and the estimate of stabilized value (NOI/Cap Rate) as prepared by the appraiser. CBFIs typically incorporate this same appraisal provided information in the underwriting of commercial real estate opportunities.

The base case in the example utilizes what might be a typical underwriting structure. This includes an 80% LTV and a 20-year amortization. In this base case, the LTV of 80% is within the policy for most CBFIs, but the estimated DSCR is .99x, below a typical minimum policy requirement for DSCR of 1.20x. The debt yield (NOI/Debt) is 7.5% in this example. Under this type of structure, a CBFI might reject this credit opportunity based on the less than 1:1 DSCR.

But wait, the deal is not yet lost. A slight change in the underwriting to adjust the amortization period from 20 years to 25 years improves the estimated DSCR to 1.12x, a level much closer to the comfort level of many CBFIs. The deal becomes even more attractive when adjusting the amortization to 30 years, resulting in an estimated DSCR of 1.23x, well within the comfort level of many CBFIs. It is important to note in each of these examples, the debt yield remained constant at 7.50% despite the improved traditional DSCR resulting from a change in the amortization period.

The example below demonstrates a change in the NOI or loan amount will impact the debt yield. The NOI is within control of the borrower. The LTV is a CBFI controlled underwriting factor which will either increase or decrease the amount of the loan (also affecting the debt yield). An increase in the approved LTV will increase the loan amount. An 85% LTV in the example reduces the debt yield from 7.50% to 7.06%, and a decrease in the LTV to 75% provides an increase debt yield of 8%.

Regulatory Definition and Underwriting Use Recommendation

The OCC includes in their *Commercial Real Estate Lending Handbook for Safety and Soundness*, "Debt yield provides a measurement of risk that is independent of the interest rate, amortization period, and capitalization rate. Lower debt yields indicate higher leverage. This measure can be especially useful during periods of low interest and capitalization rates, periods during which loan amounts established by using the DSCR and LTV ratio may be prudent only as long as the low-rate environment is sustained. Debt yields that reflect normalized or higher-rate levels can be used to establish stressed loan amounts that are less vulnerable to higher-rate environments. Debt yield provides a common metric to quickly size up a

loan or assess its risk. Debt yields vary according to market conditions and property types, with higher debt yields recommended for riskier properties. Debt yield, when used, should be considered along with other criteria and loan amounts and be supported by prudent DSCR and LTV ratios."[1] The Handbook encourages a minimum debt yield to be included in CRE lending policies and potential financial covenants.

The debt yield measures the cash-on-cash return on the CBFI's investment (loan) against the property. This is different as opposed to the borrower's return on equity (ROE), which is based on the borrower's cash-on-cash return against their invested equity. The debt yield can also facilitate further analysis of the CBFI's risk of the overall loan portfolio as debt yields compare across borrowers and industries.

Practical Use

The current data available regarding the use of a debt yield often refers to a minimum required debt yield of 10%. The data also suggests the debt yield may be lower for less risky property types and higher for more risky property types. The process of setting an appropriate policy debt yield level could lead to extensive research and calculations to determine debt yields across property types suitable for a specific CBFI. I would suggest setting an initial policy debt yield metric near industry standards (10%) may provide the best opportunity for incorporating this additional, simple, and meaningful tool. The initial debt yield level may be addressed as underwriting and management become more familiar with the use of a debt yield. Additionally, the debt yield can be stress-tested in most underwriting processes the same as interest rates, NOI, DSC, and LTV.

Recent market conditions provide for low-interest rates and cap rates based on a historical perspective. Loan amounts determined by a combination of DSCR and LTV may offer limited comfort in a rising interest rate environment. Incorporating debt yield as an additional underwriting tool is both simple and has the potential of adding value from a risk identification perspective. I encourage CBFIs to consider enhancing their analysis by adding debt yield as an evaluation tool in the CRE lending policy.

[1] Comptroller's Handbook, Safety and Soundness, Commercial Real Estate Lending, Version 2.0, March 2022

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Example

New Mini Storage Units

Per Appraisal

	As Stabilized
Valuation	$8,039,000
NOI	$482,336
Cap Rate	6.00%

	Base	25 YR Amort	30 YR Amort	85% LTV	30 YR Amort & 85% LTV	30 YR Amort & 75% LTV
Interest Rate	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
Amortization	240	300	360	240	360	240
LTV	80%	80%	80%	85%	85%	75%
Estimate of Value	$8,038,933	$8,038,933	$8,038,933	$8,038,933	$8,038,933	$8,038,933
Loan Amount*	$6,431,147	$6,431,147	$6,431,147	$6,833,093	$6,833,093	$6,029,200
Monthly Payment	$40,687	$35,746	$32,586	$43,230	$34,622	$38,144
DSCR	**0.99**	**1.12**	**1.23**	**0.93**	**1.16**	**1.05**
LTV	**80%**	**80%**	**80%**	**85%**	**85%**	**75%**
Debt Yield	**7.50%**	**7.50%**	**7.50%**	**7.06%**	**7.06%**	**8.00%**

**The loan amount is based on the Estimate of Value multiplied by the LTV factor*

The Estimate of Value is based on the NOI/Cap Rate

Kevin Graff is the President of Integrity Loan Review. He has significant experience with loan review and credit administration. He is happy to discuss your loan review and other related questions. Kevin can be reached at 920 – 857 -6225 or emailed at kevin@integrityloanreview.com