NECESSARY COMMERCIAL KNOWLEDGE FOR LOAN OFFICERS

1. SIX TYPES OF LEASES

A. **GROSS LEASES—requires the tenant to pay a gross rent, with the landlord paying taxes, maintenance, and insurance.**

B. **PERCENTAGE LEASES—sometimes called an overage lease is often used for retail tenants. A minimum (base) rent is charged, plus a percentage of the tenant's gross sales over a predetermined threshold.**

C. **NET LEASES—sometimes called a net, net, net lease (triple net) implies that the tenant is responsible for taxes, maintenance, and property insurance.**

D. **ESCALATOR LEASES—the owner and the tenant determine a base amount for expenses, such as taxes, utilities, insurance, and maintenance. The owner's obligation to pay expenses exceeding the base amount "stops" and passes through to the tenant.**

E. **INDEX LEASES—requires changes in the rent based on some published index, such as the Consumer Price Index.**

F. **STEP-UP LEASES—sometimes called a graduated lease has rent increases built into the schedule of rents.**

FINANCIAL AND INVESTMENT RATIOS

Financial Statement Ratios -- offer the investor an opportunity to compare the subject property's operating results with other similar properties. These ratios are based on the pro forma operating statement for a typical year.

1. **Debt Service Ratio—this ratio is based on the perceived riskiness of the projected NOI.**

Net operating income divided by Annual debt service = Debt Service Coverage Ratio

2. **Operating Expense Ratio—gives the investor a view of the effectiveness of management in comparing like properties (businesses) expenses.**
   Operating expenses divided by Effective gross income = Operating Expense Ratio

3. **Cash Break-Even Ratio—it is the percentage of potential gross income that an investor must collect to break even.**
   Operating expenses minus reserves + annual debt service divided by Potential Gross Income = Cash Break-Even Ratio

4. **Margin of Safety—is directly related to the cash-break-even ratio. While the cash break-even ratio gives a sense of the occupancy level required to break even, the margin of safety shows the other side of the equation, the vacancy ratio.**
   1 minus the cash break-even ratio = Margin of Safety

5. **The overall capitalization rate (OAR) also called the return on investment (ROI)—would be the investor's return if he or she paid no mortgage. The OAR includes both debt and equity and helps an investor value income property.**
   Net Operating Income divided by Value = OAR

6. **The rate of return on equity (ROE) sometimes is called the cash on cash return.**
   Before-tax cash flow divided by Equity = ROE

7. **The loan constant (k) is the constant annual percentage of the original loan amount required as principal and interest payments. Calculated by dividing the annual debt service by the original mortgage principal.**
   Annual debt service divided by Original mortgage balance = Mortgage Constant

If the annual constant on the debt service is less than the overall rate of return (OAR), the result is positive leverage.

8. **Calculating the down payment based on the investor's return standards is as follows:**
    A. **Net operating income minus Debt service = Before-tax cash flow**
    B. **Before-tax cash flow divided by Required rate of return = Down payment**