

What is debt yield and why is it important to commercial lenders?

Quick, name the three most commonly used metrics by commercial real estate lenders to assess the inherent risk in making a real estate loan. If you got stuck after quickly rattling off loan to value and debt-service coverage ratio, you are not alone. If you've been in the market lately for a commercial real estate loan, you may have heard the term debt yield. Debt yield is the newest metric used in assessing risk and considered by most securitized lenders to be the most important. But what is debt yield and why do lenders care about it?

Loan to value is probably the most well-known risk ratio used by lenders. In today's lending environment, maximum LTV varies across asset and lender types; life insurance companies tend to lend between 60 percent to 65 percent of a property's value, while commercial mortgage-backed securities lenders are more aggressive, lending up to 75 percent of a property's value. Acknowledging market volatility and the subjectivity of capitalization rates, many lenders have become skeptical of the accuracy of LTV. Was a cap rate derived from in-place net operating income or Year 1 NOI? What type of rental growth was a buyer assuming? Is there a large amount of rollover risk in the near term that the buyer is taking into consideration with the purchase price? Because selecting a cap rate for lenders' internal underwriting purposes can be subjective, lenders have become more apprehensive toward LTV as the most important risk assessment metric.

The other most well-known metric, debt-service coverage ratio, measures the extent to which a



Dan Konecny
Associate, Essex
Financial Group,
Denver

property's NOI covers debt service. Traditionally, lenders want a property's NOI to cover annual debt service 1.25 times at a minimum. DSCR, however, can be manipulated and influenced by outside factors. In a volatile interest rate

environment, swings in Treasury rates and credit spreads can have a large effect on DSCR. In addition, one can engineer DSCR by lengthening a loan's amortization.

The main differences between debt yield and other risk ratios is that debt yield does not take into consideration cap rates, interest rate or amortization. Debt yield is simply a property's NOI as a percentage of the total loan amount (debt yield = property NOI/loan amount). For example, a commercial real estate property with a \$100,000 NOI collateralizing a \$1 million loan generates a 10 percent debt yield. Conceptually, debt yield is the return a lender would receive if it were to foreclose on the property on Day One. Debt yield can be thought of as a lender's perspective of the cap rate, the cash flow a property generates relative to a loan amount or lender's basis. Using a debt-yield ratio helps balance a value that may be inflated by low cap rates, low interest rates and high leverage.

Debt yield gives a lender insight into how wrong things can go before the lender won't be made whole on its investment. A lender

would rather invest in a 4.5 percent coupon rate loan on an asset with a 12 percent debt yield than on one with a 7 percent debt yield. In its simple context, the property with a 12 percent debt yield has more cash flow and the chance of default is less likely. It's an apples-to-apples way for lenders and buyers of securitized loans to compare each individual loan. Everything else equal, a \$1 million loan on a property generating an NOI of \$120,000 is less risky than on a property generating an NOI of \$70,000.

Debt yield has become the ratio of greatest importance to conduit lenders securitizing fixed-income loans and is arguably becoming more and more important to life insurance company lenders. In today's commercial real estate lending environment, the rule of thumb for a minimum debt yield is 10 percent. That said, minimum debt yields can vary by market and product type. In Denver right now, the minimum debt yield required for downtown office and Class A apartments are 8.5 percent and 7.5 percent, respectively. The less risky an asset type or more primary the market, the lower the acceptable debt yield. Over the past couple of years, competition to place debt has forced lenders to reduce these minimum thresholds.

Debt yield provides lenders with a tool that removes subjectivity and helps lenders navigate an inflated market. Lenders will continue to utilize LTV and DSCR; however, in today's low interest rate and compressed cap rate environment, lenders will continue to gravitate toward and put more importance on debt yield to assess their risk and relative basis.▲