OTHER INVESTMENT RATIOS

GROSS RENT MULTIPLIER

The Gross Rent Multiplier (GRM) is basically the multiple of the annual rental income that you receive for your investment dollar.

$GRM = \frac{P}{R}$ Purchase Price divided by annual gross Rents.

So, if monthly rents total $5,000, annual rents equal $60,000 ($5,000 x 12 months)

Then if the purchase price is $600,000, the GRM is 10.0 $\frac{\$600{,}000}{\$\ 60{,}000} = 10.0$

If the purchase price is $700,000, the GRM would be 11.7 $\frac{\$700{,}000}{\$\ 60{,}000} = 11.7$

It the purchase price is $550,000, the GRM would be 8.3 $\frac{\$500{,}000}{\$\ 60{,}000} = 8.3$

A low GRM is desirable as an indicator of value since you are then paying a lower multiple of the annual rental stream.

The benefit to this ratio is that it is easy and you can even do a version in your head off the monthly rents. It does provide a quick way to rank properties when you are initially comparing them. Your commercial broker can provide you with past and current Gross Rent Multipliers for past sales and current listings in any given market.

The disadvantage is that it does not take expenses into account and expenses can vary widely from new to old buildings or one type of property to another (i.e. retail buildings with NNN leases where tenants pay most expenses compared to apartment buildings where the owner is responsible for most of the expenses). Also, below market rents will skew the Gross Rent Multiplier too high unless a prospective investor plugs in the actual true market rents into the equation for comparison purposes to other properties.

DEBT COVERAGE RATIO

The Debt Coverage Ration (DCR) is the margin of safety that is required by commercial lenders between the mortgage payment and the net operating income.

$$DCR = \frac{\text{NOI}}{\text{Mortgage Payment}}$$

Net Operating Income divided by the the mortgage payment

Since we usually know what the lender's requirement is for debt coverage and we know the net income of a building, we are usually solving for the mortgage payment so we can estimate how much the bank will lend on the property.

For example: the bank wants a 20% margin of safety over the mortgage payment (expressed as a 1.20 DCR). The building has a NOI of $60,000 ($90,000 rents less $30,000 expenses).

$$1.20\ (\text{DCR}) = \frac{60{,}000\ (\text{NOI})}{X}$$

Solving for X: 1.20X = $60,000 X = $50,000

If the annual mortgage is $50,000, the monthly payment would be $4,166 ($50,000 divided by 12 months). Using a financial calculator or tables, knowing the current interest rate is 7%, the principal amount that $4,166 would pay on a 30 year loan is $629,834. If the price of the building is more than $629,834 the lender will require a larger down payment to satisfy its safety requirement. A Debt Coverage Ratio of 1.2 is a common requirement for most commercial loans for multi-family properties of 5+ units.

LOAN TO VALUE (LTV)

The Loan To Value is the opposite of the down payment percentage since it is the maximum percent a bank will lend on a property.

$$LTV = \frac{\text{Loan Amount}}{\text{Purchase Price (or appraised value on a re-fi)}}$$

Commercial banks normally have a minimum down payment which is actually a maximum they will lend (the LTV ratio). Lenders talk in terms of a 75% LTV rather than a 25% down payment. However, that is a minimum requirement. The debt coverage ratio (DCR) must also be met. In the example of the building above whose income would cover a $629,000 loan, the bank does not care if the building price is $1 million. The buyer simply has to come up with the other $371,000 or 37% down, a not uncommon number today on Seattle apartments.

Note: Non owner occupied 2, 3 and 4-unit buildings for investment will finance just like non-owner occupied houses with the same residential lenders. A portion (usually 75%) of the building income is added to the buyer's existing income and he or she is then qualified based on his/her income and credit, subject to a certain minimum down payment (historically 25%). These loans are relatively easy to qualify for since the bank will only consider the borrower's personal finances when approving the loan and not the building's financial performance.

Commercial loans for 5+ unit buildings will need to be placed with specific commercial lenders who will mandate that the above investment ratios be met. Essentially, the lenders are looking at the building to pay back the loan. If the building makes investment sense and the bank ratios are met, the loan will be funded.