

Should You Take out a Loan for Commercial Real Estate? How to Decide.

When it's time to expand your business, a real estate loan might be your best bet.

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If you're the owner of a successful brick-and-mortar business, you may one day face a "good problem": *Is it the right time for you to expand and/or renovate?*

If indeed the time *is* right to expand or overhaul your current space, or even move to a new location, your business is likely thriving. That's the good part. The problem is that buying or renovating commercial space can be an expensive endeavor.

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But it's not an impossible one: To upgrade, you typically have two options: Save up funds over a long period to eventually pay in cash; or take out a loan to speed up the time line and strike while the iron is hot.

Whether you should or shouldn't take out a real estate loan isn't a cut-and-dried question. The answer will depend on your needs as a business owner, of course, but also the costs of your commercial real estate, the types of loans you qualify for and other factors such as the time you'll need to pay off your financing.

Here's what you need to know about real estate loans before making that decision:

Why take out a real estate loan?

The most simple answer to the question of "Why take out a real estate loan?" is that commercial real estate is, for many small business owners, prohibitively expensive. According to Green Street Advisors, commercial property prices were at an all-time high as of early 2019.

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Debt financing in the form of a real estate loan is one of the few options for small business owners who need access to enough capital to buy or renovate real estate. Other options, such as the receipt of venture capital or a grant, are highly competitive and difficult ways to acquire funding.

Commercial real estate loans, meanwhile, can run anywhere from tens of thousands to tens of millions of dollars. Part of your loan application process will be to explain to your lender why you need the amount you've applied for, and you'll need to take into account the fees and expenses related to your loan.

Investing money into an initiative centered around real estate requires careful planning. Your expansion or renovation must bring a return on investment that matches – or better yet, exceeds – what you spent on your loan.

What types of commercial real estate loans are available?

Not every commercial real estate loan is created equal. Different lenders and agencies offer a variety of terms that may cut your costs by thousands of dollars, or require you to put down a smaller down payment upfront – if you qualify.

Traditional commercial real estate loans: Banks offer commercial real estate loans the way they do other business loans. Real estate loans from a bank will typically offer the most money, with the lowest rates, of any financing you might find.

The down side? It's difficult to qualify for a bank loan. At a minimum, you'll need to show excellent personal and business credit, and own a business that's operated with strong margins for at least a few years.

SBA commercial real estate loans: When small businesses need affordable financing and they can't get approved by a bank, they turn to the Small Business Administration. The SBA has two loan options that may be used for real estate: The SBA's general purpose 7(a) loan program and its 504/CDC loan program.

Both offer rates that are far more affordable than what you would get from a hard-money lender (more on that option below), with payment terms that can last as long as 25 years. Of the two programs, the 504/CDC loan is the better choice for real estate loans: Interest rates start at around 5 percent, compared to 7 percent to 10 percent for 7(a) loans.

Hard money real estate loans: A hard-money loan is another term for a short-term loan from private lenders and investors. Typically, a hard-money loan will be for a smaller amount, and come with higher interest rates than does a loan from a bank or the SBA.

The upside? Hard-money loans come with less stringent qualifications than bank loans. Newer businesses that can't demonstrate the business history or strong credit scores that more established business owners can tend to start with hard-money loans.

Commercial bridge loans: A bridge loan is a short-term loan that is meant to be paid off quickly or refinanced into a

longer-term loan. You might take out a commercial bridge loan to quickly capitalize on an opportunity for expansion, rather than waiting for a traditional or SBA loan application to get approved.

You can get a bridge loan from a bank or a hard-money lender, but know that this is a stop-gap solution before you find a better option.

Commercial real estate crowdfunding: An increasingly popular way to raise funds for any kind of venture or project is through crowdfunding. Receiving many small loans or donations from lenders and investors can add up to an amount similar to a hard-money loan – or more, if you're savvy.

Do I qualify for a commercial real estate loan?

As noted, your qualifications for a commercial real estate loan will depend on what kind of loan you're looking for. Getting approved for a bridge loan from an online lender will be easier than for a traditional bank loan, for example.

That being said, there are some factors to keep in mind when you apply for a real estate loan; these factors will help improve your chances of getting an affordable loan offer, no matter where you apply:

- **Credit score:** The higher your personal credit score, the more likely you'll be approved for a traditional or SBA loan. Around 700 is the minimum. For a hard-money real estate loan, most lenders want a credit score of 550 or higher.
- **Real estate collateral value:** What is the value of the property you're looking to purchase? Real estate loans are "asset-based," which means the property itself will act as collateral on the loan and can be sold off if you

don't make payments. Therefore, lenders will want to know how much this property is worth. That way, they'll know whether they'll make their money back in the event that you fail to pay them.

- **Time in business:** The longer your business has been around, the less of a risk you'll appear to be to lenders.
- **Debt service coverage ratio:** Your DSCR is a calculation of your net annual income, divided by your loan payments. This gives lenders an idea of whether you'll be able to make your regular payments each month. A DSCR of at least 1 tells lenders you're a good bet.

What else should I consider before applying?

When considering a real estate loan, here's what else you should consider besides the types of loans available and their relative qualifications:

The more affordable the loan, the longer the repayment term: Typically, affordable real estate loans will have longer repayment terms. For example, 504/CDC SBA loans can have repayment terms lasting decades.

This is a double-edged sword: On one hand, no one payment will take a massive chunk of your monthly profits. On the other, you'll be in debt for a long time before you have the ability to pay off your loan in full. Make sure that you're comfortable with this reality before embarking on a multi-year endeavor.

The bigger your down payment, the better: If you recognize an excellent opportunity for expansion or renovation but don't have the necessary funds on hand, you get a real estate loan.

That doesn't mean, however, that you can approach a lender with zero cash or no collateral.

The loan-to-value (LTV) of your loan is affected by whatever down payment you can afford to contribute to your loan. The bigger your down payment, the lower your interest rate – and, of course, the less you'll have to pay back.

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Loans as a stepping stone to success

A real estate loan might be the stepping stone you need to take your small business to the next level. Without careful planning, however, it can put you on the path toward increased financial debt without a viable return on investment. That's why careful planning is essential in order to determine whether a loan is an option you can afford.

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