

# Financing that Great Property you Just Found

## INTRO

**Cash Flow Is King!** We have all heard it a thousand times. The term comes from the business world as it is critical for any business to create cash flow. However, the term can be deceiving if left unchallenged. For example, I can show you business after business that have a great cash flow- well over \$1,000,000 per year- yet are going bankrupt. Their expenses are far greater than their income- lots of money coming in but even more money going out. On the other side I have also seen very small businesses that well out perform the perceived competitive giants with tons of cash in their pocket after April 15<sup>th</sup>. I have seen the exact same thing happen between properties. Duplexes that out-perform 20 unit complexes (as measured by positive Cash Flow After Taxes). Now let's relate these "business" issues back to being a more successful investor.

The same thing happens with investors. You may find yourself talking to a group of other real estate investors in any number of venues. Many such conversations are bragging arenas about their holdings. They are proud of their accomplishments and typically brag about the NUMBER of properties they own or their last purchase. The assumption is that the more properties they own the more money they are making. I am here to tell you that this is RARELY THE CASE. I have clients that have purchased properties that out perform the average investment property purchased five to one (data analysis based on multi-family units purchase in Western PA in 2008)! If you have been reading my newsletters for any length of time, you know that *It's not about the number of properties you own, but the amount of money in your pocket after April 15<sup>th</sup>.*® This statement drives home the necessity for me to KILL OFF the old adage Cash Flow Is King and to replace it with one more focused on a productive business approach. The new phrase is: **"Positive Cash Flow After Taxes is King."**® With that important foundational thought set, we are not in a position to better understand the approach that banks and lenders take when lending you money to purchase that next great piece of investment property.

There are two basic factors that lenders look at when providing you lending for any purchase: your credit score; and your debt to income ratio. Below I will provide some insight into each and then move quickly into how lenders rely on both scores to approve loans and how to calculate your own DTI score.

## Credit Score

Your credit score is known today as your FICO score. This "credit scoring system" was created in 1956 by an engineer, Bill Fair, and mathematician, Earl Isaac. They called their company Fair Isaac. It was built on the principal that business decisions could be improved by using data intelligently. The first company to use the new credit scoring system was Montgomery Ward in 1963. It wasn't until 1991 that the credit scoring system from FICO (Fair Isaac and Company) was adopted by the three credit reporting agencies: BEACON<sup>sm</sup> at Equifax, EMPIRICA<sup>®</sup> at Trans Union, and the Experian/Fair Isaac model at Experian.

Your FICO score is made up of five basic factors. These five factors effect your score differently. The five factors are:

- Payment History: Most recent 12 months- 40%, 13-24 months- 30%, 25-36 months- 20%, 37-48 months- 10%
- Capacity- 35%: Effecting factors are a) amount you owe versus where you started; b) revolving account balance, and total revolving account balances
- Length of Credit History- 15%: Tip: Do not close out any old accounts even when \$0 balance
- Types of Credit- 10%: Looks at overall types of credit and dept
- New Credit- 10%: Looks at number of accounts, length of accounts, recent requests for credit cards, etc.

As you can see by these breakdowns, the number thing, you need to do, to keep your FICO score at its highest level, is to make sure you make all your payments on time. I have seen even one late payment made six months earlier change the lending answer from a definite yes, to a definite no!

## Debt to Income Ratio

So, if FICO scores were the predominant and sole criteria for lender approval after 1995, what lending criteria did lenders use before 1995 to approve loans? The answer: Debt to Income (DTI) ratio calculations. DTI ratios, and GDTI (Global Debt to Income) ratios have been used continuously and the main criteria for commercial lending approval. A debt to income ratio can be defined simply as the amount of a consumer's monthly income that goes to pay their debts. There are two different levels of DTI ratios. The first is the Front Ratio- this is the percent of income that goes for housing costs. For home owners this would be the total monthly payment for the property, equal to PITI (principal, interest, taxes, and insurance). The second is the Back Ratio- this is the percentage of income that goes to pay all recurring debt. This figure includes the Front Ratio and includes other payments for such debt as: credit cards, car loans, medical, furniture, student loans, child support, alimony, legal judgments, etc.

Fannie Mae's guidelines for the Front Ratio is 28% and for the Back Ratio is 36%. When your debt service calculates higher than either of these two percent factors, the lender may require you to take certain actions to help you fall within the parameters, may take on a stronger co-signer before providing the loan, not provide the loan, or secure other assets to lower their risk.

### From the Field: How Lenders Really Make Decisions

Historically there have been two separate and distinct methods for meeting lending criteria when buying real estate: 1) FICO score; and 2) DTI ratios. In today's economic conditions and marketplace neither factor alone is sufficient to make lending decisions. Currently BOTH factors will be used by the lender to make lending decisions on your project. Please know the focus of this writing is investing in real estate, specifically when buying non-owner occupied properties.

**FICO score:** Typically a lender will want to check your score, and the score of any other co-borrower, for the project. This "inquiry" or "tapping" into your credit score may effect your score, but usually only a point or two at best.

**TIP:** *In this first meeting, ask the lender NOT to pull your credit score but to assume for sake of lending, that you have a credit score of \_\_\_\_\_ (for example: 695) and ask them What would the lending parameters be for a credit score at this level or higher? Loan products usually break at: 720, 680, 640, etc. Taking this approach will help to keep you credit score at its highest level.*

Remembering that your credit score is a "risk" factor that predicts your payment in the future, the lender will use your FICO score to identify which type of lending package you qualify for and thus the amount of interest you will pay. Having a credit score of 640 will provide fewer lending product options with higher interest rates than a person with a credit score of 720 which will have more options and a lower interest rate. FICO scores are used as a front end sorting mechanism by lenders. Your score helps to "get you in the game." Without an qualifying credit score you could find yourself pitching your dream from lender to lender...forever!

### Debt Service Coverage Ratio (DTI):

OK. You have gotten through the initial stage and the bank says they think they might be able to help. But, before they can commit, there is some information that they will need. Then they give you a list of items that will help you prove to them you can afford the property (email me at [MaxWilson@MaxBusinessGroup.com](mailto:MaxWilson@MaxBusinessGroup.com) and request the document: **Required Documents for Loan Application**).

Once they receive all the items on the list, they will calculate your current DTI and then recalculate you DTI by including the current property cash flow into your score to get a Global DTI (GDTI). The GDTI percentage will have the greatest impact on you getting the loan or not.

However, you can impress the lender and help reduce the time it takes for the **lender to say yes** to your project if you go into your initial meeting with: 1) all the documents they will request from you; and 2) your DTI and GDTI ratio scores (see my [February 2009 Real Estate Investment Newsletter](#) and look for section: **Calculating DTI**).

If you don't have the comprehensive worksheet here is how you can calculate your DTI. The formula for DTI is simple. Add up all of your yearly gross income and divide by 12 to get your Monthly Gross Income. Then add up all of your Monthly Recurring Debt payments (credit cards, mortgages, car payments, etc). Divide your Monthly Recurring Debt figure INTO your Monthly Gross Income to get your DTI score. The bank will be looking for a score around 41% or less. Next calculate your Global DTI score.

To calculate your Global DTI score, all you have to do is go back and add in the Cash Flow Before Tax (CFBT may be positive or negative) figure from the property you want to buy. For a commercial loan, add in 100% of the CFAT for the property into your yearly income and again divide by 12 to get the Global Monthly Gross Income. If you are using a residential, Fannie Mae loan product, you only get to use 75% of the CFAT. Again, add that figure into your yearly income and divide by 12. Again, divide the new Global Monthly Recurring Debt figure into the Global Monthly Gross Income to get your GDTI score. Again, the bank will be looking for a score of 41% or less. If the score is higher, the lender will look at other options and or provide insights into what you need to do to get the score into the acceptable ranges.

### Conclusion

To recap, here are some things you can do to increase your chances of getting the loan: 1) Be prepared! Take all of the documents that you know the bank will request, a financial analysis of the property or at least all the information about the property including rent rolls, taxes, expenses, IRS Schedule E, etc; and a copy of your DTI and GDTI worksheet to the bank. You should also be able to provide the bank an estimate of your credit score and in the initial phase, have them make assumptions about that score to provide you with options. If they see that BOTH YOU AND THE PROPERTY meet their lending criteria, and they believe they can help you get the lending for the project, then sign off to allow them to pull your credit score. AND, don't let them know if you are shopping around for the best deal. You should have already done that over the phone before you went to their office.

If you are really serious about the property you may want to purchase a **REIA Report: Investor Analysis**. This report was designed to help investors provide themselves and lenders a comprehensive analysis that includes a financial profile for both the investor and the property- one so complete that lenders have been know to make pre-qualification decisions in under 10 minutes!

If you have any questions about how to fund that great property you just found, or if you would like to find out more how I help my clients maximize returns when buying, selling, and investing in real estate in the Western PA, give me a call or email me to set up a convenient time to talk.

Thank you in advance for the opportunity to serve. I hope you found this writing of value.

*Max*

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