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Watch for lease accounting changes when entering loan covenants

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As the economy continues to recover, the volume of real estate transactions has increased and banks are lending more. All excellent signs for the real estate industry. However, interest rates are slowly trending upward. Rates are still near all-time lows, but interest rates will be on the rise. Locking in a low interest rate now, or protecting the downside with a hedge agreement on a variable rate agreement would both benefit the investor in the long-term. With the increase lending activity, along with the increase in rates, some banks may be looking for more in the way of loan covenants as well.

Debt service coverage ratios are becoming more prevalent in mortgage agreements. The ratio of net income to debt service has been a standard covenant in many real estate mortgages. Typically lenders look at a minimum debt service ratio of 1.25 to 1. Depending on the transaction and risk profile, that may increase slightly.

Over the last few years, the requirement that the maximum loan to value ratio, the amount of debt the lender is willing to lend based on a property's value, has decreased. Currently loan to value ratios in the 70% to 80% range are common. Some lenders will lend up to 85% depending on the specific asset.

In addition, lenders may be looking for personal guarantees or escrow reserves as a condition of financing. However, everything is negotiable. Depending on the specific investment, creditworthiness, or loan to value ratio, lenders may waive the guarantee provisions or adjust the reserves as necessary.

As a typical provision in most commercial mortgages, many lenders require audited financial statements in accordance with Generally Accepted Accounting Principles (GAAP). When entering into a new mortgage today, the financial covenants are calculated in accordance with current accounting standards. However, it is important to keep an eye on potential changes in accounting standards that could impact how covenants are calculated. For example, let's say you are looking to acquire a property with a long-term lease in a prime location. One example of a proposed change that could have dramatic implications as to how covenants are calculated is the proposed changes to the lease accounting standards. Given today's accounting rules you may pass the debt service coverage of 1.25 to 1 without much problem. However, when and if these new standards become part of GAAP, you may wind up failing the covenant simply from an accounting method change and not a change in the economic status of the property. With proper planning, you may be able to avoid this unintended consequence.

As is true of most provisions of a debt agreement, covenants and reporting requirements may be negotiable, and before finalizing a debt agreement you should consult with your professional advisors to see what options should be considered.

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