Understanding Debt-Service Coverage Ratio (DSCR)

Real estate investing is a lucrative strategy to make more money. Between residential and commercial properties, there are many opportunities for you to turn a profit and improve your financial outlook. Rental property investments are especially attractive.

Rental properties can be cash cows for property owners because they earn money from monthly rent. That means once all the expenses for each month are paid, such as maintenance fees, mortgage loans, insurance, and taxes, the rental income that remains is money in your pocket

However, the purchase price of a rental property is a significant barrier to entry — most people don't have enough income to cover the costs of multiple mortgaged rental properties. Fortunately, there is a tool lenders can provide to help you get a foot in the door.

In this post, we're going to take a closer look at how Debt-Service Coverage Ratio works and how DSCR help investors build large rental portfolios. We also show you the DSCR calculations for you to use to help determine the profitably of your real estate investments.

Debt-Service Coverage Ratio or DSCR loans enable real estate investors to qualify for an investment property based on rental income generated rather than personal income. These loans are ideal for self-employed investors, investors with multiple mortgaged rental properties, and investors looking to grow their portfolios rapidly.

What Is A DSCR Loan?

Unlike a consumer or owner-occupied mortgage loan, but similar to a commercial real estate mortgage, a DSCR loan is underwritten based on property-level cash flow, rather than personal income. DSCR or Debt-Service Coverage ratio is a tool to help lenders understand a borrower's ability to pay back a loan based on the monthly rental income of the property. DSCR is a simplified way to measure cash flow and is calculated by dividing the monthly rent by the monthly principal and interest payments, taxes, insurance, and association dues (PITIA). DSCR ratio is a tool to help lenders understand a borrower's ability to pay back a loan based on the monthly rental income of the property.

$$DSCR = \frac{Rent}{PITIA}$$

P = Principal
I = Interest
T = Taxes
I = Insurance
A = Association dues

For a commercial or multi-family property, DSCR is calculated by dividing the annual Net Operating Income (NOI) by the annual debt service (same thing as the annual PITIA). The formula for commercial property DSCR is:

$$DSCR = \frac{\text{Net Operating Income}}{\text{Annual Debt Obligations}}$$

For example, if a property generates a Net Operating Income of $100,000 annually and its annual debt service is $81,783, the equation would like this:

$$DSCR = \frac{\$100{,}000}{\$81{,}783} = 1.22$$

The annual debt service in this example is less than the Net Operating Income, which makes the monthly cash flow positive.

DSCR Loan Property Types

DSCR loans typically can be used for the following property types:

- o Single-family (1-4 unit) residential rentals
- o Vacation or short-term rentals
- o Commercial or multifamily property

Single Family Home	Vacation Rental	Multifamily
		

DSCR loans typically cannot be used for the following property types:

- o Rural properties
- o Properties with square footage of less than 750 square feet
- o Condotels
- o Manufactured housing
- o Dome homes
- o Log cabins

Why are DSCR Loans Significant to Investors?

Minimum Down Payment

Also referred to as investment property loans, Non-QM loans, and rental loans, among other synonyms, DSCR loans have become quite trendy recently. So what is all the buzz about? While it is possible for investors to obtain a conventional loan or funds through a small bank, this financing is tedious to qualify for and has substantial liquid reserve requirements. DSCR Loans, on the other hand, are specifically designed for the professional real estate investor to use cash flow generated by the property as a qualification. Let's take a closer look.

DSCR Loans are Underwritten Based on Gross Rental Income Instead of Personal Financial History

Experienced real estate investors with multiple mortgaged investment properties and self-employed investors without W2's often have difficulty meeting conventional loan criteria. The credit, reserve, and income requirements of conventional loans are strenuous. Further, they are underwritten using Debt-to-Income ratio or DTI, which looks at your personal assets compared to your personal debt. If you are trying to finance the purchase of a rental property with a conventional loan, the payment for the new loan will be included in the debt portion of your debt-to-income calculation. Whether you can offset that new monthly payment with a portion of the expected rent will depend on how well you can document the actual or expected rents from the property.

Investors that have a lot of personal income from non-investment property sources, may be able to cover the “cash flow gap” on their DTI calculation up to some point. Investors that are self-employed or who have multiple mortgaged investment properties may not have income from other sources to cover this gap. Using debt service coverage ratio eliminates DTI from the underwriting and instead focuses on the rental income from the subject property relative to its monthly payments.

DSCR Loans Allow Investors to Borrow in an LLC or Entity

Many experienced investors prefer to borrow through an LLC or corporation to protect their identity and other investments. This adds an extra layer of protection to the investor's personal assets for any unfortunate incidents on the property. Conventional loans can only be obtained in an individual(s) name.

Most DSCR Lenders have more flexible common sense limitations on the maximum number of properties financed

Even if an investor has enough personal income to support multiple mortgaged rentals, with traditional loans you are maxed out at ten loans. Most DSCR lenders do not have set limits but instead use common sense when evaluating an investor's maximum credit exposure.

DSCR loans require less documentation

When applying for a conventional mortgage, you have to gather all of your pay stubs, bank and asset statements, and tax documentation, including tax returns. The underwriters are going to dive deep into your personal financial documents and history, which is time consuming and tedious. Any missing documentation or schedules in your tax returns can lead to lengthy delays. Since DSCR lenders focus on the value of the property and the expected cash flow of the property, plus the quality and depth of your credit, there is far less necessary documentation. Most DSCR lenders will not ask you for documentation to verify your employment, income or assets (beyond required liquid reserves).

DSCR Loan have become increasingly popular over the last several years for many reasons. One reason is that the capital markets have grown widely confrontable with non-QM loans, including jumbo loans, bank statement loans, foreign national loans, and DSCR loans.

According to CoreLogic, the non-QM share of the housing market doubled from 2020 to 2022 and accounted for 4% of the mortgage market in 2022. Also in late 2022, HouseLogic reported that JP Morgan Chase joined the DSCR Loan MBS game further boosting the assets authority in the market. Another key reason is that the lack of mortgage loan affordability (including increasing interest rates and insufficient down payment funds) and low inventory are driving a trend towards more people turning towards renting. RCLCO Real Estate Consulting notes that even though they are being out priced, living in a single family home is preferrable among renters. Millennials are entering prime housing formation years and want to live in homes with yards and multiple bedrooms, opposed to apartment units.

Finally, despite the higher interest rates, investors are finding single family rentals profitable with higher rental income than debt obligations. In a volatile market, stability is key, and SFR rental properties provide that stability. DSCR loans are a successful way to finance these properties and are a more seamless experience than other types of investment property loans.

How DSCR Loans Work

What makes a good Debt Service Coverage Ratio?

A debt service coverage ratio of 1.2 is solid , and anything above a 1.5 is strong. A DSCR ratio of 1 indicates the rent exactly equals the monthly sum of principal, interest, taxes, insurance, and association dues (if any). With a debt service coverage ratio below a 1, the investor will be subsidizing the PITIA with cash from other sources.

Let's look at some examples for a clearer picture.

WHAT IS A GOOD DSCR RATIO?

DSCR = 1	A DSCR of 1 indicates the monthly rent exactly equals the monthly sum of principal, interest, taxes, insurance, and association dues (if any).
DSCR < 1	With a DSCR below a 1, the investor likely will have to come out of pocket to cover property expenses.
DSCR > 1	While it varies between lenders, typically anything above a 1.2 is considered good, and anything above a 1.5 is considered great.

DSCR Examples

DSCR < 1

Principal + Interest= $1,800

Taxes= $250

Insurance= $150

Association Dues=$35

Total PITIA= $2235

Rent= $2100

DSCR= Rent/PITIA=2100/2235=0.94

Since the DSCR is .94, we know the PITIA is greater than the monthly rent from the property, indicating negative cash flow.

DSCR =1

Principal + Interest= $1,500

Taxes= $350

Insurance= $150

Association Dues=$100

Total PITIA= $2100

Rent= $2100

DSCR= Rent/PITIA=2100/2100=1.0

Since the DSCR is 1.0, we know the mortgage payments and PITIA expenses are equal to the monthly property rent.

DSCR >1

Principal + Interest= $1,600

Taxes= $250

Insurance= $150

Association Dues=$35

Total PITIA= $2,035

Rent= $2350

DSCR= Rent/PITIA=2350/2035=1.15

If we divide the rent by PITIA, we get a DSCR of 1.15, which indicates positive cash flow.

DSCR Loan Use Cases

At ROC Financial Solutions, we have four common use cases of our DSCR Loan product: Cash-Out Refinance, Rate & Term Refinance, Purchase, and Vacation Rental.

Cash-Out Refinance Loan

Cash-out refinances are our most popular use case. A cash-out refinance is when you replace your mortgage loan with a new loan for a higher loan amount, and the difference in cash is yours. You could also obtain new financing on a property that is not currently pledged on a loan. Our clients use our cash-out refinances to:

- Renovate an existing rental
- Buy another investment
- Finance a flip

A cash-out refinance is when you replace your mortgage loan with a new loan for a higher loan amount, and the difference in cash is yours. You could also obtain new financing on a prop.

Rate & Term Refinance

A rate & term refinance is when you refinance an existing loan in order to change the interest rates and/or terms of the loan. Commonly, investors will use a hard money loan or a fix and flip loan to purchase and renovate a distressed property. Once the renovations are complete, they will keep the property as a rental and refinance into a DSCR loan for permanent financing.

Purchases

A rate & term refinance is when you refinance an existing loan in order to change the interest rates and/or terms of the loan. Commonly, investors will use a hard money loan or a fix and flip loan to purchase and renovate a distressed property. Once the renovations are complete, they will keep the property as a rental and refinance into a DSCR loan for permanent financing.

- Purchase already rented properties
- Purchase rent-ready properties

Vacation Rentals

Unlike other lenders, we have been able to make sense of short-term rents and will finance vacation rentals. Our investors often will use our DSCR Loans to:

- Cash-out refinance a vacation rental to buy more properties
- Cash-out refinance a vacation rental to buy more properties
- Purchase a new vacation rental as an investment

Optimizing The DSCR Ratio

Simply put, the debt service coverage ratio is a ratio, and it can be manipulated by changing the numbers. Here are ways to improve your DSCR:

Charge More Rent

One surefire way to improve your DSCR, is to charge more rent for your rental property. An increase in rental income will give you more cash flow to pay your monthly mortgage payments, and therefore improve DSCR.

Lower Your Interest Rate

Lowering your interest rate will lower your monthly mortgage payments and therefore your DSCR. The best ways to guarantee a lower interest rate are to increase your down payment and improve your credit score.

Negotiate Your Taxes and Insurance

Other key debt obligations in the DSCR formula are taxes and insurance. Be sure to shop insurance providers for the best rates, though never compromise on coverage. You should also fight your property taxes annually to continue to lower your total debt service.

DSCR LOAN SURPRISES

Just like you can optimize the DSCR ratio, there are some factors that could lower your DSCR ratio. DSCR loan lenders usually require a DSCR of 1.2 or more. You may qualify initially for a DSCR mortgage, and then have some numbers come back higher or lower than you were expecting. Knowing about these DSCR surprises upfront can help investors be extra cautious when calculating DSCR to guarantee positive cash flow.

Higher than Expected Insurance

If the cost of insurance you calculated in your initial debt-service coverage ratio comes back higher, your monthly expenses will increase and therefore lower your DSCR ratio, cash flow, and ability to qualify for a DSCR loan.

Higher than Expected Taxes

Similar to an increase in insurance, an increase in property taxes will increase your monthly expenses and, therefore, your debt-service coverage ratio.

Lower than Expected Rental Income

Frequently, we see a property being leased for a rent that is higher than market value. When an investor lowers their rent and rental income, the debt-service coverage ratio goes down.

Prepayment Penalties

While this is not a surprise that will impact your ability to qualify for a DSCR mortgage, a prepayment penalty is a feature of most DSCR loans that you don't want to be a surprise. A prepayment penalty is a contractual clause that states the borrower is going to pay the lender an additional fee if the borrower pays the loan off early. This isn't necessarily a "penalty," however. Here's how it works.

A common prepayment penalty structure — and in fact, most lender's standard structure — is called a 5/4/3/2/1 structure. This means that if the borrower pays off the loan in year one, they have a 5% prepayment penalty, in year two, a 4% prepayment penalty, and so forth. If your prepayment penalty structure is a 3/0/0, it means that in the first year you pay a 3% fee, and then the penalty goes away after that. The reason the term "penalty" is not accurate is because it does not necessarily impact your DSCR loan. For instance, investors looking to hold onto their properties long-term are not impacted by the prepayment penalty. Investors who want more flexibility can take a higher interest rate to get rid of their prepayment penalty entirely.

What DSCR Is Missing

So we talked about what could lower or raise your debt-service coverage ratio, but believe it or not this is not the whole picture. Yes, you are looking at net operating income compared to debt obligations, but if you think about it an investor's monthly payments often comprise of more than just PITIA. While DSCR loans require a 1.2, there are more payments that need to be taken into consideration for the full picture of cash flow for any given property.

Property Management Expenses

With a portfolio of investment properties naturally comes general maintenance and repairs. This is not necessarily a monthly expense, however it is still important and can reflect your total debt service for the year. We recommend having savings set aside specifically for this purpose.

Vacancy Rates

"Vacancy" might as well be a curse word for a real estate investor. A vacancy means no rental income to assist with your mortgage payment. Again, we recommend every real estate investor have substantial savings to help them build their real estate portfolio. It also good practice to have Rent Loss Insurance to assist with rental income in the event of a vacancy.

Tenant Costs

The list of expenses for real estate investors goes on and on. Investment properties need tenants, which means marketing, advertising, screening, and contracting. These are not recurring expenses, yet still they can add up and impact your net operating income annually.

Income Taxes

A great thing about DSCR loans is that they don't look at your personal debt or income. However, on your annual tax returns you are going to have to include rental income. Fortunately, there are great tax deductions for landlords.

Our goal in highlighting these prevalent real estate investor costs is to show that a fantastic DSCR ratio does not mean automatic success. It is important to consider a complete picture of your debt obligations before obtaining a DSCR loan. If you think you are ready to apply for a DSCR loan, keep reading for requirements and what to look for in a DSCR lender.

Furniture

If you are using a DSCR loan to purchase a vacation rental, the DSCR calculation does not take into consideration all of the furniture you have to buy for the property. Not to mention the dishes, bedding, electronics, etc. needed to get a vacation rental property up and running.

Our goal in highlighting these prevalent real estate investor costs is to show that a fantastic DSCR ratio does not mean automatic success. It is important to consider a complete picture of your debt obligations before obtaining a DSCR loan. There are also some scenarios where a DSCR loan will not be a good fit. We'll get into that in the next section and then if you think you are ready to apply for a DSCR loan, we'll discuss the requirements and what to look for in a DSCR lender.

When a DSCR Loan is Not a Good Fit

When to Get a DSCR Loan vs. When Not To

YES	NO
Purchasing a rental property	Purchasing a primary residence
You're purchasing your second + investment property	Purchasing a distressed property
Purchasing a property value above $125k	Purchasing a property value below $125k

A DSCR loan is a powerful tool for real estate investors looking to build a portfolio of investment properties. However, DSCR loans are not ideal for everyone. Here are some examples of when you would not use a DSCR loan:

You're Purchasing Your Primary Residence

DSCR Loans can only be used to purchase an investment property. For your primary residence, you should stick with conventional mortgages.

You're Purchasing Your First Investment Property

Many real estate investors are able to obtain conventional mortgages on their first investment property. The interest rates will be lower and first time investors often have the income and documentation needed to meet the debt-to-income ratio qualifications for conventional mortgages. However, conventional mortgages can only be financed in your personal name. If real estate investors want to protect their personal assets, sometimes they will obtain a DSCR loan for their first investment property so they can finance through an LLC.

You're Purchasing a Distressed Investment Property

Most DSCR loans require rent-ready rental properties. That means no construction projects or anything more than minor wear and tear. Many real estate investors looking to flip an investment property will finance their construction through a hard money loan program and then refinance into a DSCR loan for permanent financing. ROC Financial Solutions has “NO seasoning” programs available to refinance a Fix and Flip renovation loan into a long term rental with cash out.

The Rental Income is Lower than the Mortgage Payments

If you are purchasing an investment property in a hot market where the rents have not caught up to the home prices, you will not be able to cover the monthly debt payments with rental income. Most lenders require at least a 1.2 DSCR and will not loan to you if you are unable to meet the monthly debt payments. However some lenders, like Visio, have a No DSCR Loan Program for this reason. We see the value in investing in hot markets, and will offer you a No DSCR Loan if you have a strong credit report and meet other qualifications.

The Investment Property is Low Value

Most lenders have a minimum loan amount of $75k and a minimum investment property value of $150k. Even if the rental income will cover the monthly mortgage payments, you likely will not qualify for a DSCR loan. If you don't meet the other minimum requirements. One way real estate investors pay for this kind of property is to use a DSCR loan to pull cash out of another investment property.

When to Get a DSCR Loan vs. When Not To

YES	NO
Purchasing a rental property	Purchasing a primary residence
You’re purchasing your second + investment property	Purchasing a distressed property
Purchasing a property value above $125k	Purchasing a property value below $125k

DSCR Loan Requirements

If you are an investor and looking to obtain a DSCR mortgage, make sure you meet these basic requirements:

o **Minimum Credit Score Required:** Most DSCR lenders require a 680 credit score (ROC Financial Solutions - 620) with better rates for higher credit. Most lenders also have minimum tradeline requirements, including both amount and duration. Lenders also will consider whether you have any other significant credit events on your credit report, such as foreclosures, bankruptcies or past due payments.

o **Minimum Down Payment or Equity:** Maximum loan-to-value on purchase loans typically is 70%-80% and on refinances is 65%-75% (ROC Financial Solutions Max cash out refinance LTV 80%) depending on property type, credit and DSCR.

o **Minimum Property Value:** Most lenders have a minimum property value of $150k (ROC Financial Solutions $100K).

o **Minimum Loan Amount:** A good standard for minimum loan amount is $75k.

What To Look For In A DSCR Lender

When comparing DSCR lenders, here are some considerations.

What are the lenders rate and fees?

It is important to know what your costs will be for the loan. The last thing you want is to end up at the closing table with unexpected costs. Most lenders charge an origination fee and one or more administrative fee (underwriting fee, processing fee, documentation fee). Also be on the lookout for a prepayment penalty if you are looking to sell the property in the near future.

What are the lender's eligible property types?

This may seem obvious, but it does vary between lenders. For instance, some lenders have DSCR Loan Programs for vacation rentals and others do not. Other common variations include warrantable vs. non-warrantable condos and multi-family vs. single-family homes.

Is the lender focused on and experienced in working with investors?

ROC Financial Solutions specializes in investment and commercial real estate only.

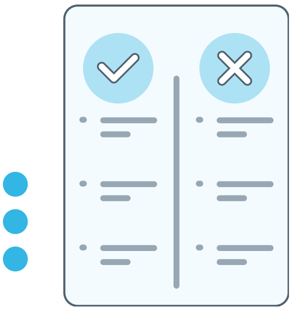
In our opinion, this is the most important consideration. Lenders who work with investors often understand the nuances associated with financing and have programs tailored to help investor needs. There are a lot of new DSCR lenders on the market. Here are some things you can look for to help hone in on the most experienced lenders:

- o Ask about the number of DSCR loans they have closed
- o Ask how long they've been offering and closing DSCR loans
- o Ask whether they have a dedicated team of operations personnel that process and underwrite their DSCR loans
- o Ask about their property insurance requirements, because they typically are materially different for investment properties as compared to owner-occupied properties
- o Ask about their prepayment penalty or rate buy-down options. DSCR loans almost always have a prepayment penalty
- o Ask about the ability to finance in an LLC or corporate entity

Pros and Cons of DSCR Loans

DSCR loans are an option that have grown in popularity recently due to their use of rental income rather than debt-to-income ratio to evaluate whether you qualify or not.

They are easier to qualify for than an agency or bank loan and have lower interest rates than hard money loans for financing an investment property. However, there are also drawbacks that should be considered when it comes to this type of loan program.



DSCR Loan Pros:

- · • DSCR loans often have faster application and closing times without the need to submit personal financing documents or tax returns.
- · • There's also more flexibility on the number of loans or properties, so scaling your business can be done more quickly if you can afford it.
- · • Protect your personal assets by financing a DSCR loan through an entity or LLC.

DSCR Loan Cons:

· • Typically, they require a higher down payment (often 15-25% of the property's value).

· • Interest rates and lender fees are also higher for a DSCR mortgage than a second home loan.

· • You'll need to provide proof of experience in renting (either STR or LTR).

DSCR FAQs

What will my rate be on a DSCR mortgage? DSCR loans interest rates are normally 150 bps to 300 bps higher tan consumer rates. They are higher because investment properties are a much higher risk than owner-occupied homes.

How can I improve my DSCR ratio? The easiest way to improve your DSCR ratio is to increase your down payment, however you can also shop insurance, fight the property taxes annually, and charge a higher rent. Allowing pets or including upsells such as a washer and dryer are easy ways to add more to your rental income.

Why do Lenders care about DSCR? In additions to credit score, DSCR is an indicator of a borrower's ability to pay back a loan based on the cash flow generated by the rental properties income.

What is a No-DSCR loan? A more accurate description for this program is a "Low DSCR Loan". Essentially, this product does use the DSCR, but has additional qualifications. Many lenders, like ROC Financial Solutions, offer a No-DSCR loan option for investors in strong markets where the rents have not caught up with the property values.

Why do DSCR loans have prepayment penalties? Mortgage loans are expensive to originate. It is not uncommon for consumer mortgages to cost upwards of $9,500.00. Lenders typically recoup these cost over the life of the loan. If a borrower pays off the loan shortly after origination, the lender is at risk of losing money on the loan.

Why You Should Partner with ROC Financial Solutions for Your DSCR Loans

· Financing DSCR loans requires specific expertise and differs from other loans in terms of:

· *Underwriting Requirements:*

· As an example, personal income history is not a consideration when underwriting DSCR loans.

· *Appraisal Process:*

· For a DSCR loan, an evaluation is needed of comparable rents in the area is needed in addition to the standard property appraisal report.

· *Borrower Types:*

· Often a real estate investor finances properties in an entity, which in itself has some lending nuances. For instance, there are necessary entity documents.

Our DSCR Loan Features

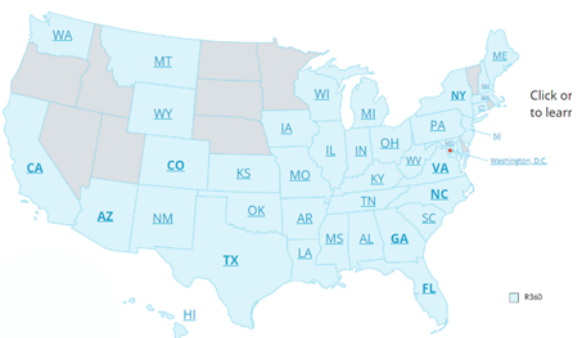
· Low documentation; no personal DTI, no tax returns;

· Full 30-year terms with no balloons; and

· The ability to protect your identity by financing through a corporate entity

· Common sense underwriting of your short-term rents

· Nationwide DSCR Loans



This DSCR (Debt Service Coverage Ratio) loan training PDF has provided you with a comprehensive understanding of the key concepts, calculations, and considerations involved in evaluating DSCR loans. By mastering the fundamentals of DSCR analysis, you are equipped to make informed decisions when assessing the feasibility and risk of commercial real estate financing.

Remember, the DSCR is a vital metric used by lenders to assess the borrower's ability to service debt obligations, and it plays a crucial role in determining loan eligibility and terms. By accurately calculating and interpreting DSCR ratios, you can effectively evaluate the financial health and sustainability of potential investment opportunities.

Continued practice and application of the principles outlined in this training will further enhance your proficiency in DSCR analysis, ultimately empowering you to navigate the complex landscape of commercial real estate finance with confidence and success.

We hope this training has been valuable in expanding your knowledge and skill set in the realm of DSCR loans. Should you have any further questions or require additional assistance, please do not hesitate to reach out to our team of experts. Thank you, and we wish you continued success in your real estate endeavors.

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