Commercial mortgages and lenders

If you decide to buy property for your business, you will probably need a commercial mortgage. Before you take one out, it is essential that you consider the maximum monthly mortgage repayment your business can afford. You should also take into account the potential growth of your business, as relocating too often can be costly.

This guide explains what information a commercial mortgage lender will need from you, professional advice available and the various costs. It also looks at the pros and cons of buying compared with renting, explains how to choose a lender and where to get further help.

An overview of the commercial mortgage

You may need to take out a commercial mortgage to buy premises to start or expand your business, or if you are buying a business that is directly linked to property, eg a hotel or retail outlet. Mortgages are usually for 15 years or more and the property itself is at risk if payments are not made on time.

Meeting the lender's criteria

Most banks and building societies offer commercial mortgages, but you must satisfy their criteria. Most lenders require a positive personal credit rating and clear evidence that your business is creditworthy, although some lenders may accept applications where there is an adverse credit history.

Most lenders will apply a **loan-to-value ratio** and will expect you to invest a proportion of your own money in the purchase. The more you are willing to invest of your own money, the greater the chance you will have of securing a loan for the remainder.

The loan-to-value ratio is the loan amount divided by the current market value of the property expressed as a percentage. If a property has a current value of £200,000 and a loan is required for £150,000, the loan-to-value ratio is 75 per cent.

The lender's decision will also depend on your current business circumstances - a commercial lender will expect your business to be stable and profitable. They may ask to see your business plan and long-term financial projections, to assure themselves that your business has, and will continue to have, the ability to make repayments on the loan. For further information, [read about different types of commercial mortgages on the Decision Finance website - Opens in a new window].

Some lenders may impose restrictions on the uses of commercial premises, eg your ability to sublet to other businesses and certain business concerns may be excluded altogether. You will need to consider carefully all the terms of any lending agreement, particularly as the loan period may be for 15 years or more. This is a complex area and it's essential that you seek specialist advice from your solicitor and probably a chartered surveyor.

Pros and cons of buying business premises

Buying commercial premises can be a good investment - owning a property gives your business stability and the property itself can become a significant asset. However, it is a major step and before you commit it is important to think carefully about the pros and cons.

Advantages of buying business premises

There are considerable advantages to buying:

- your mortgage repayment is likely to be similar to a rental payment on the same property
- with a fixed rate mortgage, your monthly repayments will be predictable
- you aren't exposed to any sudden rent increases
- you may be able to sublet any free space, reducing your monthly repayments (you may require permission from your lender to do so)
- interest payments on a commercial mortgage are tax-deductible
- any gain in value of the property will increase your capital
- as your business grows, you may be able to extend your existing premises, avoiding relocation costs

Disadvantages of buying business premises

Disadvantages include the following:

- Unlike renting, you'll need to come up with a substantial deposit - this is money that might be used for more important business purposes.
- If you own premises, you may find it harder to relocate your business, because selling business premises is not always easy. If you rent, you may be able to negotiate to end your rental agreement, or to find another organisation to take over your tenancy.
- If you have a variable rate mortgage, you are exposed to increases in interest rates.

- Owning a property means you'll be responsible for factors such as maintenance, fixtures and fittings, insurance, decoration and security.
- Any fall in the value of the property will decrease your capital.

What lenders need to know

Any mortgage lender will want to be sure that your business is on a sound financial footing before agreeing to a commercial mortgage.

A lender's **main concerns** are that:

- you will be able to repay the money
- the property is worth enough to cover the amount borrowed if you default

Set an upper limit of what your business can afford to repay every month. Don't be tempted to over-borrow - doing so could deny your business the cashflow it will need to grow. Do not overestimate the value of a property. A lender will almost certainly appoint a surveyor or property appraiser to inspect and value the premises.

You will be asked to provide information about your business' **financial performance**, which will probably include:

- audited accounts for the last two years
- indications of current performance
- a profit-and-loss forecast for the next year
- business bank statements for the previous six months
- identification of each partner or director in your business for credit-checking
- asset and liability statements for each applicant
- a business plan showing how the property will contribute to your cashflow and how you intend to repay the loan

If you are buying a business and property combined, it is likely you will need to supply the lender with additional information, such as:

- why the business is being sold
- projections on how the business is expected to grow
- details of any personal investment there might be
- credit status of the business

Bear in mind that you will almost certainly need to find a deposit - normally at least 25 per cent of the purchase price of the property. However, depending on the availability of security or other factors, some lenders may be more flexible.

Different types of lender

High street banks and building societies are not necessarily the best places to start looking for a commercial mortgage, although major banks often have advisory services which can be helpful. If you have a good relationship with your bank, it is worth checking to see if they can help you.

It may be worthwhile locating a **specialist lender** who understands the specific needs of your industry. There are also many lenders online. Be careful which one you choose and ensure that they are certified - for more information, see the page in this guide on finding a lender.

Using a mortgage broker

A mortgage broker's role is to help you to find the best mortgage to suit your needs, giving you **impartial advice** on products and steering you through the mortgage application process. Once you have successfully obtained your mortgage, your broker will be willing to continue to monitor the market to make sure you are getting the best deal.

It's important - particularly for small businesses - to get the right kind of finance at the best price. Many commercial brokers work in specific business sectors and someone working in your sector might be able to help find you a special deal.

Using a broker can save you a lot of time, as they have specialist market knowledge and will be able to find certain deals that are only available through brokers. They may not charge you a fee if they receive commission from the loan providers, but be willing to negotiate if they do - see the page in this guide on commercial mortgage fees and costs.

Check that your broker is independent - instead of being tied to just one lender - and will consider all the available options.

You can search for specialist commercial finance brokers on the National Association of Commercial Finance Brokers (NACFB) website - Opens in a new window.

Finding a lender

If you decide to arrange your own mortgage, rather than using a broker, there are various options, such as talking to business contacts, your own bank, financial advisers or your accountant.

The internet offers access to hundreds of lenders who offer instant quotes and advice. If you are happy with a quote you find online, it is recommended that you telephone the lender in person before signing up - you may find you can get an even better deal and can also confirm details.

You may prefer to discuss your needs with potential lenders in person - talk to your own banker as well as an adviser at major banks and building societies which provide commercial mortgages.

You could seek specialist advice on what sort of mortgage will be best for you. Search for specialist commercial finance brokers on the National Association of Commercial Finance Brokers (NACFB) website - Opens in a new window or contact NACFB directly on Tel 01392 440040.

The Financial Services Authority (FSA) has changed the regulation of mortgage companies to give you greater clarity and protection over their products. Read the guidelines on mortgages on the FSA's moneymadeclear website - Opens in a new window.

Repaying a commercial mortgage

Commercial mortgages may carry higher interest rates than residential loans because you are considered a higher risk - particularly if your deposit is lower than 25 per cent. The term of the loan will be at the discretion of the lender and is typically between ten and 20 years.

Interest rates

There are two interest rate options - variable or fixed. Rates are usually set between 1 per cent and 6 per cent above the Bank of England base rate, but you should be prepared to shop around and negotiate for the best deal.

Most commercial mortgage schemes have **variable** rates and will fluctuate in line with the Bank of England base rate. Your repayments may rise or fall and you should budget accordingly.

A **fixed** rate means your repayments are fixed for a certain period of time, usually two to five years. At the time when the rate is fixed, it will usually be higher than the variable rate, but it will allow you to plan your budget more reliably. At the end of the fixed rate period the rate may change to a market variable rate or you may have the right to renegotiate the loan.

Repayment methods

Different kinds of mortgages are repaid in different ways. With a **repayment mortgage** - sometimes called a capital and interest mortgage - you repay a portion of the loan and the accrued interest each month.

An **interest-only mortgage** means only the interest on the debt is paid off with each monthly payment. To be eligible, you may need to have an accompanying insurance or pension policy that will mature at a value close to the outstanding lump sum. You will certainly need to show that you will have the means to pay off the loan at the end of the term.

You should seek advice from a suitably qualified financial adviser before committing to a mortgage that relies on the proceeds of an investment or a pension to repay the loan. If you have an existing product, such as an endowment mortgage, you should also seek regular financial advice due to changes in the stock markets.

You can search for a financial adviser on the Association of Independent Financial Advisers (AIFA) website - Opens in a new window.

Commercial mortgage fees and costs

Interest rates vary according to the lender and the repayment options you choose.

Other fees and costs include:

- **Arrangement or processing fees** - these are fees that your lender charges for arranging your mortgage. A typical fee might be in the region of 0.5 to 1.5 per cent of the loan and is usually negotiable.
- **Valuation fee** - this is the fee charged by the lender for carrying out the valuation of the property and can vary according to the lender. Further costs are incurred if the lender insists upon a full structural survey to establish the valuation.
- **Redemption penalty** - if you pay off your mortgage early, you may have to pay an additional amount, which is also known as an early repayment penalty. This is usually applicable in the first three to five years of the mortgage, although it can sometimes apply after that.
- **Legal and professional fees** - these can include insurance, site surveys and preparation of legal documents.

There are certain other factors of which you should be aware:

- **minimum level for the loan** - commercial mortgages are usually only given for substantial amounts, ranging from £15,000 to over £1 million, with higher sums in

other circumstances depending on the value of your property and the nature of your business
- **period of grace** - some lenders are flexible about late payments, underpayments or payment holidays - but you may incur increased interest charges
- **personal guarantee** - if you run a limited company, the bank may ask you for a personal guarantee as additional security, especially if the amount of cash you are investing is limited

See the page in this guide on repaying a commercial mortgage.

Here's how I took out a commercial mortgage to buy a pub

John Topping
Sangton Ltd

John's top tips:

- "Carefully prepare your business plans and financial projections before you approach any lenders."
- "Discuss with your lender how much headroom you'll need to avoid any cashflow troughs."
- "Don't be afraid to negotiate hard - especially on guarantees."

John Topping is managing director of Sangton Ltd, a small chain of pubs in the North West. Most of his business properties are leased but when he found the ideal premises for his first operation in Bolton he needed a commercial mortgage. It helped finance the purchase and transformation of the then car-parts shop and Italian restaurant into the 800-capacity late-licensed cafe-bar that is now McCauleys.

What I did

Work with the financial institution which best understood the nature of our business

"On the basis that you've really got to look around when you're spending so much we looked at a few of the key players offering mortgages. However, we found there was little to choose between them so we went with the Co-operative Bank who had had our banking business from day one. I think it helped that we already had a successful relationship with the manager there and we used the opportunity to renegotiate the whole of our banking deal.

"The bank also offered us a repayment holiday for the first year. That was important as we were using our own cashflow to part-finance the purchase and I knew there would be little left in the first year for repayments - especially given the early and big push in marketing that's essential to get a bar operation going."

Write a full set of business projections and get all the relevant permissions

"I was confident that what we needed to borrow would be more than covered by the returns on the actual property. Still, I had to put together a full forecast and business plan. I did the plans myself and being very professional when doing it must have helped because we had mortgage offers from all the banks we approached. I think it gives them confidence in you.

"Before getting the mortgage I also had to prove we could get the premises licensed as it hadn't been a pub before, get the planning permission required for the refurbishment, and have a full valuation done. That was all very frustrating. It took more than 18 months from start to finish to get the mortgage and things did change over time. That meant we had to keep updating our forecasts."

Draw on the mortgage in stages

"We took the money only as and when we needed it over the purchase and refurbishment period. I'd arranged to borrow £700,000 but in the end I actually only borrowed £600,000. This was because the project took longer than anticipated and cashflow from the rest of the business continued to grow. From that point of view, drawing on the mortgage in stages worked really well."

What I'd do differently

Negotiate harder on personal guarantees

"I think I've put quite a lot on the line to take out the mortgage. My personal property is now acting as a guarantee and I think I could have arranged a better deal than that. It's a psychological point really but when I apply for a commercial mortgage again - and I will do this - I think I'll be tougher on it."

Business Link Helpline

0845 600 9 006

RICS Enquiry Line

0870 333 1600

Related web sites you might find useful

Commercial mortgages information on the Decision Finance website
http://www.decision-finance.co.uk/commercial_mortgage_guide.html

Download buying business premises guidance from the Institute of Directors website (PDF, 166K)
http://www.iod.com/intershoproot/eCS/Store/en/pdfs/pr4buy.PDF

Download business premises rental guidance from the Institute of Directors website (PDF, 155K)
http://www.iod.com/intershoproot/eCS/Store/en/pdfs/pr3rent.PDF

Search for a solicitor on the Law Society website
http://www.lawsociety.org.uk/choosingandusing/helpyourbusiness/foryourbusiness.law

Search for a chartered accountant on the Institute of Chartered Accountant in England and Wales website
http://www.icaewfirms.co.uk/section.asp?catid=16&docid=2

Search for a specialist commercial finance broker on the NACFB website
http://www.nacfb.org/broker.html

Mortgage guidelines on the FSA's moneymadeclear website
http://www.moneymadeclear.fsa.gov.uk/products/mortgages/mortgages.html

Search for an independent financial adviser on the AIFA website
http://www.aifa.net/consumer-area/ifap.php

Bank of England base rate information on the Bank of England website
http://www.bankofengland.co.uk/mfsd/iadb/Repo.asp?Travel=NIxIRx

Search for a chartered surveyor on the Royal Institute of Chartered Surveyors website
http://www.ricsfirms.com/vw/search/location.aspx