The Sudden Fuss About "Debt Yield"

In my earlier years as a lender, I recommended a $15 million acquisition loan that was to be secured by a retail center. The solid credit tenants on long-term leases supported the 7.5% capitalization rate, which was the minimum cash-on-cash rate of return my borrower/buyer was prepared to accept on his investment. Based on the property generating $1,500,000 of net operating income (NOI), the maximum price my borrower was willing to pay was $20,000,000 (NOI ÷ 7.5% Cap Rate).

I recommended the loan based on the conservative cap rate, NOI coverage and 75% loan-to-value ratio. After approving the deal, my credit officer said: "As a commercial lender, we should achieve a Debt Yield of at least 10%, and focus less on Cap Rate".

Debt Yield is the rate of return on the loan (a lender's expected return upon foreclosure). It is the same calculation as a Cap Rate (NOI ÷ Purchase Price), except the denominator is the loan amount instead of the Purchase Price. In this example, the Debt Yield is 10% ($1,500,000 NOI ÷ $15,000,000 loan). It ensures: (i) a safe LTV ratio, and, (ii) that the NOI should adequately cover debt service on the loan, provided the interest rate is comfortably less than the Cap Rate.

The Point Is This: *The concept of Debt Yield has been around forever, but it is forgotten at the top of every economic cycle and resurrected at the bottom. Here we go again – the banks have finally remembered what they had forgotten.*