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A Full Service Commercial Real Estate Company

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Commercial Real Estate Investment Newsletter

Everyone Wants Apartments

Of the housing starts and new building permits in recent quarters, apartments outnumbered single-family homes. The demand for rentals remains very strong. Owners of foreclosed homes have added to the demand, moving from homes to apartments. Although most people favor detached home ownership, many in the population cannot afford a single-family home.

A new buyer of apartments must think "management". Good management has always been the most important point in increasing or maintaining annual operating profits. Being a skillful manager requires intelligent handling of the functions of buying and selling properties, rent collections, maintenance, leasing, controlling expenses, refurbishing, management accounting and more. All of this requires long "hands-on" experience in the field with plenty of assistance from the latest in operational and administrative hardware and software. Professional management companies usually do a much better job than owners and more than earn their fees.

Here are a few tips on types of apartments and ways to invest in them.

The Market

Apartment properties, as always, continue to be the favorite investment property for many investors in 2012. Of course, these investors purchase income producing real estate to make money. One of the advantages that apartment property offers investors is the higher ratio of building to land value which means that more of the capital investment can be depreciated. Also, the depreciation life of residential income property is shorter than other investments.

It is also possible to reap substantial rental income from a relatively small investment, with a large amount of the purchase price being financed by first and second mortgages.

Looking at an apartment property for investment, you must

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have an idea of where your tenants will come from:

Downtown High Rise. The advantages of the downtown apartment are its accessibility (both for work and shopping) to the business heart of the city, and the cultural and entertainment facilities available. Higher prices of gasoline make these more desirable. However, because of high rentals, it is not surprising that studies show that the luxury-apartment dwellers (1) were over 35; (2) had relatively high incomes; (3) either worked downtown or did not work; (4) had no children living with them.

Fringe-Area Medium-Rise. Cost considerations often prevent these in the downtown area, but they may be feasible in fringe areas. They are attractive because they have a friendlier atmosphere than the high-rise. A typical tenant profile for such a project showed that most had moved there from single family homes, were over 45 without young children, and were self-employed or professionals.

Garden Apartments. These generally fall into the middle-income or semi-luxury class. In one Southern city, a study showed about half the tenants in a project were single and sharing space, while the other half were married couples with few or no children and both working. Average age was low and most commuted to work without finding the trip burdensome.

High-Value Garden Apartments. These appeal mostly to older persons who want to live in the suburbs without having the responsibility of a house. The apartments tend to be large, both in terms of space and number of rooms.

Suburban Luxury High-Rise. These are often popular in high-income suburbs near fairly large cities. They combine the full range of luxury features (swimming pools, organized social activities, etc.) with the advantages of suburbia (less congestion, adequate parking, modern shopping facilities). Usually, these projects are located at or near key access routes.

Studies have also shown that the reason most often given for selecting a particular apartment project is its accessibility to the job. Most emphasis is on travel *time* rather than *distance*. Less crowded roads or fast expressways open up a wider territory for rental projects. After-work accessibility, the feature people want most is convenient shopping, which in the suburbs means access to a shopping center. Thus land adjacent to a center is often highly desirable for a rental project if it can be acquired at the right price.

Location. If the apartment fits these criteria for tenants, check the location and surrounding neighborhood. You don't know what you're buying unless you take a hard look at the neighborhood in which the apartment is located. How does the building compare with other buildings in the area? What are others offering to tenants in the same neighborhood? How do rentals compare? What about transportation facilities? How close to the business area are you? Make a careful study of schools, recreation and shopping facilities, traffic flow, and churches. An analysis of these factors is essential.

Layout. Study the number and layout of the apartments, average rent per room, and prospects for increases. How competitive is the rental level? Don't automatically assume that the rental level is equal to the rental value. Remember that an apartment rented at a bargain price in a financially well-off community has more rental value than high-rent premises in a declining area. Also, a low-rent apartment in a fashionable neighborhood will bring more than a much better apartment in a middle-income area.

Condition. Before investing, the physical condition of the property must be checked. Whether or not the building and the grounds are in good condition may make the difference between profit and losses for you. Look carefully at the age and type of equipment used. Check for signs of deferred or substandard maintenance. Otherwise, you may find that you will be faced with abnormal costs after you acquire the property. If you expect to get the same rentals as other buildings in the neighborhood, the appearance of your buildings and grounds should compare favorably with the others.

However, a property that is in poor physical condition may be just what you want if you are renovating apartment buildings.

Upgrading Apartments

Many investors specialize in picking up run-down

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properties and renovating them for sale or lease. Profit can also be made in acquiring properties that offer extra land. It is sometimes possible to not only get your money back, but also make a profit on the sale of a remodeled house with a reduced amount of land (assuming the local zoning ordinances will so allow), while holding the additional land for long-term appreciation or building another house or small apartment on it. In addition, many larger houses that might otherwise be considered uneconomical can be trimmed down to accommodate a family seeking more spacious quarters. By reducing the structure's surplus space, many sprawling houses can be made salable. It is also possible to buy a large house, remodel it to a duplex or more units (with zoning approval) and sell it with a good profit.

Benefits In "Rehabbing" Apartments And Houses

Low Front-Money Requirements. Less front money is required for many rehabilitation jobs than for comparable new construction, since the building shell is valuable and less material is required.

Maximum Use Of Work Crews. If the investor is a builder, he can buy or option buildings and start working on them during slack construction periods. In this way, he keeps construction crews busy for the maximum amount of time.

Cash Flow. A rehabilitated building can bring the investor a steady rental income providing cash flow and profits with tax shelter produced by depreciation deductions.

Quick Action. As the rehabber gains experience, a builder can complete work on an older building in less time than it takes to put up a comparable building from scratch. Usually, a rehabilitated building will produce more rentable space than a similar new structure because of modern building code requirements.

A Rental Portfolio. A portfolio of rehabilitated houses and apartments should produce a relatively high rate of return with only a limited risk. As they appreciate in value, periodic refinancing of the buildings is possible. In this way, the investor can cash out part of the equity tax-free. Also, refinancing can produce substantial funds for new construction and rehabilitation projects. Later, when the buildings are sold, the gain will be taxed at favorable capital gains rates.

After the purchase, continue with the most professional actions by employing a professional real estate management company. ❏

Taxes And Exchanges

Q. We are making a tax deferred exchange of our commercial property up into a large apartment property. The apartments have some deferred maintenance so we would like to take some cash – about $40,000 - out of the transaction for some upgrades. My accountant now tells me that any money taken out of the transaction will be taxable to me. Is this true?

A. Yes, the accountant is correct. If you take $40,000 cash out of the otherwise tax deferred exchange transaction under Internal Revenue Code 1031 you will owe capital gains tax on that $40,000.

But do not worry. There may be a way around it. It is always a tax-free event when you refinance a property you already own. You can receive tax-deferred cash either before or after the exchange transaction, but not as part of the exchange. Do not take the cash at the closing of the transaction.

For instance, you can refinance the commercial building before entering into the exchange transaction or you can refinance the apartment after you close the exchange.

Since it sounds as if you have already started the exchange, it might be best to take the money out of the apartment by refinance after the closing.

Take this idea to your accountant and see if he/she agrees. ❏

Controlling Property With The Least Expense

The Purchase-Option

A purchase-option contract lets the buyer-optionee purchase a property at a specific price within a certain period of time. If the option is exercised, a closing is held and the property is purchased at the price previously agreed upon. There is no legal obligation to buy the property. But, if the optionee does not exercise the option, the deposit paid to the seller-optionor is forfeited.

The biggest differences between the purchase-option and direct ownership may be two advantages from the viewpoint of the investor: First, the short term (6 to 24 month) purchase option contracts can be an outstanding way to control property without assuming the responsibilities of ownership. Second, the contract enables the optionee to receive all of the benefits from appreciation in market value of the property.

Basic Responsibilities in "Doing Business" Eliminated

There are five basic responsibilities of property ownership that are eliminated by using the purchase-option contract:

Long-term Commitment. With many investments, there will be no cash profit from property ownership until the property is sold. With the purchase-option, the responsibility for a long-term commitment of ownership is eliminated. The optionee's commitment is short-term only, with the ability to sell the option, buy and immediately sell the property, or never buy the property.

Mortgage Payments. There are no mortgage payments made by the optionee. He has eliminated the responsibility to "pay for" the property during the period when the purchase-option is open and unexercised.

Property Management. There will be no responsibility with respect to managing and maintaining the property unless the optionee exercises the option and takes possession of the property. In a straight purchase, the buyer must begin maintaining and managing the property right after closing--a time consuming and costly responsibility.

Cash Payments Required. As we all know, property ownership involves payment in full or cash down payment (10% to 25% or more). When the property is controlled with the purchase-option, the down payment is replaced by an option deposit (the consideration in the contract), that can be in a much smaller amount, perhaps in the 1% to 5% range.

Financial Liability. Optionees have no financial risk in the property other than the amount paid in the option contract. The property owner must pay the property taxes, mortgage payments, insurance payments, maintenance and repairs and any other obligations of ownership.

The optionee has the specified period of time that is in the term of the option in which to buy the property or decide to pass. During the time, the optionee can evaluate the potential and make those decisions. It is certainly the best way to hold a property for an increase in value over a very short term.

Control Of Property

Most real estate investors have traditionally been attracted to commercial real estate opportunities. Typically these investors have been well rewarded for their investment. Properties that are designed for "doing business" proliferate and succeed as businesses grow and diversify and become more and more profitable. For investors to be successful it is normally important to understand the operation of the particular commercial enterprise involved in the real estate investment.

However, some investors look for the short-term investment with less of an emphasis on "doing business" and more pre-investment research on controlling property for the maximum gain in the short term. These investors often use the option or purchase-option. ❑

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate.