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A Full Service Commercial Real Estate Company

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Commercial Real Estate Investment Newsletter

Taking Over A Neglected Investment Property

It is hard to believe that someone can totally neglect a valuable investment property like a multi-unit apartment. It happens. The run down property may have been acquired from a seller who did not understand real estate investments and failed to manage it at all.

The professional investor can usually spot the low-priced and currently unprofitable income property that can be purchased, then upgraded with some reasonable expense so that it becomes a cash flow property. That property can then be added to the investor's real estate portfolio or quickly sold for a profit.

First, a professional management company must take over the property. It is faced with a problem property that the new owner has purchased for the purpose of a "turn-around" for profit.

The new manager must first develop a plan that will help the investment become a success as soon as the new owner takes physical possession. This plan must be short term to get the rents coming in and long term to make it a productive property in the future. The following are some points in a typical plan to create a profitable investment from an underperforming apartment building.

Standard Procedures And Accounting Functions

Rental activities and property management functions must be centralized.

Management was probably nearly nonexistent or the units would not be underperforming. Management efficiency must be improved immediately. For cash flow, rent invoices are mailed on time and payments from tenants can be sent directly to the bank for deposit. Computer financial software can be used for budgeting and for cash management.

A professional management company will already have standard procedures set up and designated employees to carry out maintenance and repairs (schedules for regular tasks such as pool cleaning and lawn mowing as well as routine requests by tenants for minor repairs such as leaky faucets or cracked windows).

Examine Operating Costs For Possible Reductions

After budget is set up, all operating expenses and actual expenditures must be compared to the budgeted amounts. Analyze whether tenants should be required to pay for utilities and whether the real estate tax assessment should be protested. (Tax assessment might reflect the time before the property was underperforming.)

Improvement To The Property

Over-improvement of the property too soon can be a mistake. Concentrate

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first on improving the physical condition of vacant units; then consider making improvements for occupied units that will justify a higher rent when lease is renewed.

An effective way of controlling capital improvement costs is by adopting a regular maintenance program with the standard procedures.

Are Leasing Policies Adequate?

Assess the current leasing policies regarding tenant credit checks and screening, discounts for signing or renewing leases, security deposit amounts, and procedures for dealing with delinquent rents. Search for new ways to alter the tenant mix in the underperforming building so as to generate greater profits. Policy changes regarding base rent, for example, may impact favorably on the vacancy level and on payment delinquencies, resulting in a more profitable building as a whole.

Remarket The Rentals

Check the local population and economy to see if the property might be remarketed. An example could be a building that was occupied primarily by college students. It might be remarketed to employees of a new computer plant that is opening nearby. The building could be more profitable when occupied by employees who can afford higher rents, cause less wear and tear, and have less turnover. ❏

Apartments Are The Favorite Investment

Investors purchase income producing real estate to make money. Apartment properties, as always, continue to be the favorite investment property for many investors.

It is 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.

An advantage that apartment property offers a buyer is the usual higher ratio of building to land value that means that more of the capital investment can be depreciated. The depreciation life of residential income property is shorter than other commercial properties. Straight-line recovery for buildings is claimed over a period of 27.5 years for residential rental property vs. 39 years for nonresidential real property.

The Demand For Rentals

Year in and year out the demand for rentals remains strong. Most people would like to own their own home, but many in the population cannot buy a house. The demand for apartments (and the rental rates) spikes up whenever interest rates rise.

The most important point in increasing or maintaining annual operating profits has always been good management. 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. This requires long "hands-on" experience and training 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. ❏

Advantages And Risks Of Single Tenant Properties

Around 25% to 35% of the value of commercial properties are *single-tenant properties* (STPs). This large percentage means that institutional investors such as pension funds, as well as smaller investment groups must consider this type of investment. There are many uses ranging from office to industrial to retail. They can include office buildings, warehouses, department stores, supermarkets and other retail use. There are advantages and disadvantages in this type of ownership compared to multi-tenant properties.

Types of Single Tenant Properties

- **Corporate sale-leasebacks.** Most of the STP properties are corporate properties that have been sold to third parties and simultaneously leased back by the corporate seller, often for a long term. The usual reason for the seller was to raise additional cash.
- **Build-to-suit.** Build-to-suit (BTS) generally refers to office, industrial, or warehouse facilities constructed for a single user and designed specifically

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for its particular needs. In an over-supplied market, BTS eliminates the rent-up risk for developers. The completed building is either held by the developer or is sold to a third party who simultaneously enters into a long-term lease with the user.

- **Existing STPs**. The third form includes multi-tenant buildings that ultimately are occupied by a single tenant that expands space plus the two preceding types that are leased to third parties after the original user vacates. Since all in this group are "second generation" tenants, buildings in this category are often older than other STPs.

Convertibility To Other Use

The major consideration to an investor is whether the building can be converted to related uses at a low cost. This rules out special use properties such as refineries or manufacturing facilities. It may also rule out some corporate headquarters or institutional office buildings, constructed to meet business objectives of the original user. Often these were built without regard to capital outlays or ease of maintenance.

Warehouse and distribution facilities might be easily subdivided provided that the original design did not include a central access. They can be obsolete quickly if transportation patterns change.

Retail properties may require considerable alteration to create suitable individual stores. Service and customer access must be available for each unit. Parking may not be adequate with a larger number of tenants.

Advantages

The major advantage of the STP is the absence of any short-term re-leasing risk plus a known cash flow for the term of a long lease. Another consideration is the minimal management requirement on the investor since the properties are usually leased under net leases.

Risks

The obvious risk is when a tenant does not renew the lease or the business fails. The vacancy rate immediately jumps to 100%. Time to find a new tenant or to renovate the property can be very costly.

A STP may not be any riskier than a multi-tenant building, providing the lease is long and the tenant is a high quality company. Risks can be minimized by requiring tenants to have high credit ratings and by providing in the lease that rental payments must continue under all circumstances except possible destruction or condemnation of the building (in which case, insurance proceeds or the condemnation award should reimburse the owner's capital investment.)

A STP that fits all of the qualifications for a good investment can be a worthwhile acquisition for the institutional or individual investor. ❏

The Right Investment At The Right Time

Now may be the time to start thinking of the next real estate investment.

You must pick the right property for you. Sometimes, even the best thought out plans do not work out. Investments in real estate can turn out badly even in the best of times. Investors may then blame the loss on the "real estate cycle" when there were mistakes that could have been avoided by better planning and analysis.

Based on data obtained through interviews with more than 200 real estate practitioners, several costly mistakes were identified and discussed. Here are three of them:

Misjudging demand. Developers have faced costly setbacks by assuming that customers existed without undertaking adequate market analysis. For example, a retail development designed to attract shoppers from executive ranks in the adjoining commercial center failed to realize that high-income executives have demanding work schedules and tend to shop during their leisure hours near their suburban homes. Clerical workers, who might shop during lunch or break periods, cannot afford up-scale store prices.

Faulty property analysis. Investors invite catastrophe by failing to thoroughly examine all physical aspects of property improvements, including size, structural stability, and mechanical systems. Some investors have suffered losses by relying on ballpark estimates of rehabilitation costs or by purchasing multi-unit buildings after seeing only representative sample units carefully selected by sellers.

The investment fallacy. Too many people have equated real estate investment with a more passive "buy low, sell high" investment in assets such as stocks, gold, and stamps. They have failed to recognize that time, talent, and work must go into maintaining and enhancing a property's value. They have failed to understand that income properties and "investment" properties are largely the fruits of imaginative and capable management. ❏

Getting Tenants Into A Difficult Property

When an investment property is located in an overbuilt market, the marketing effort must have good planning and direction. Just throwing large amounts of money into the effort can be a waste. Rather than broad advertising, a narrower action may be required. Keeping the local brokers who specialize in leasing constantly updated about the amenities of a certain building may be the best way to make it more marketable.

Here are some other ideas:

• Choose the management company carefully. The agency must be professional enough to give service as exclusively as if this building was the only property represented. They must truly know the unique benefits of this building and must be enthusiastic about it.

• The outside appearance and landscaping must be first rate. Too many developers have made the mistake of cutting the landscaping budget when construction costs soar. That is the single worst thing that they can do. Before anyone can see the inside, they see the outside and it has to be inviting.

• The management company must use imagination and do unconventional things to periodically get the building into the spotlight of local news.

• Stay away from quick fixes, such as free rent. That is the very worst thing possible. People in the community will remember it for years and it will give the property a permanent bad reputation. It is the "kiss of death" and makes potential tenants shy away. The free rent offer switches the tenant's positive approach about whether the space and location is suitable to a negative skepticism about what is wrong with the building.

• The professional approach is to stress the positive features of a building and work with potential tenants to match the criteria the tenant feels are most important to him.

• What amenities do similar properties in the area have that this building doesn't have?

• Contact all tenants in nearby buildings and invite them to compare this building to their current location. There are always some who are nearing the end of their lease and have not had time to look at any other rentals. This is the time to make a "money" offer. It is acceptable to offer to pay for part of a new tenant's move by a small rent concession than to offer free rent. ❏

Real Estate Investment Consultants

When you need professional advice and help in commercial real estate you must come to our office. We are experts in values and knowledge of the entire market in this area. If you have been looking for a certain type of property we probably have the full information on several like it already.

Today's investor in real estate must have a grasp of market conditions and potential that is usually beyond their own available time to attain. Investors need assurance about the true condition of the market. With increased competition, the market place is becoming more complicated. As your professional commercial real estate advisors, we are in the position to represent you in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate

More investors are turning to real estate consultants as a means of providing a sounding board for their ideas as well as expertise in the planning and construction stages for their projects.

Feasibility studies are essential for commercial office, industrial, resort and hotel investors. With this kind of information, planning is better and there is less chance for error.

Real estate investing is not just the structure and the land. It is investing in the type of property that you want at the price and terms that suit you at the time you want to make the purchase.

We can be your consultants. ❏

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.