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Commercial Real Estate Investment Newsletter

The Potential Profits of Upgrading

When you look around a community, you will usually find a number of properties that need to be upgraded. When you want an increased return on an older property it may be time to modernize that property. Some existing owners do not recognize the increased return that they could get or do not want to make the necessary investment. Often these buildings can be acquired at a price that reflects the return based on the current condition.

When you set out to modernize an older building, you will encounter physical deterioration, functional obsolescence, or economic obsolescence.

Physical deterioration starts immediately after the building is completed and continues throughout its entire life, unless it is handled along the way with proper maintenance and repair. This type of deterioration usually can be taken care of by routine repairs and replacement of parts. Anytime the acquisition of a run-down building is being considered, the investor must be certain that the deterioration has not become so bad that the building will have to be demolished.

Functional obsolescence happens when the property loses its usefulness as a result of changes in styles or in the needs of tenants. As an example, an older apartment property could have an electrical system that is inadequate to handle modern appliances such as air conditioning, microwave ovens, computers, television or other recently developed equipment. This type of obsolescence can be cured usually by installing updated equipment.

Economic obsolescence is a change in value that is caused by circumstances that are not directly related to the property. Often this is a change in the neighborhood, such as a change in the use from residential to commercial or industrial. When this has happened, modernization of the building may not be worthwhile. If the building is structurally sound, it could be a good prospect for conversion.

Ways To Modernize A Building

There are five ways usually used to modernize a building. These are: (1) structural changes; (2) architectural changes; (3) functional changes; (4) mechanical replacements; and (5) aesthetic improvements.

When a building is quite old, structural changes may be needed for safety reasons. Before you purchase the building, an inspection should be made by a professional engineer. This can determine whether the building is structurally sound and what changes, if any, will have to be made.

The building can be partially redesigned with architectural changes during the modernization. If a building has very distinctive architectural features rather than a plain exterior, some investors feel that the property has a greater investment potential. ➠

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Functional changes and mechanical replacements can reduce costs in an old building and increase efficiency. Wiring will usually need to be replaced to provide safety for modern electrical and computer equipment. Old heating systems will usually be inefficient and cause high maintenance costs, and should be replaced. An example of a mechanical replacement would be a change from a manned electric elevator to an automatic system for a saving in labor costs.

Aesthetic improvements are the sprucing up of the property and can usually be done at a relatively low cost. When an investor is looking for a quick resale, this type of improvement may be done rather than some of the others. Cleaning up the property, inside and outside, installing new lighting and repainting the building can be enough sometimes to make a quick, small profit.

Why Modernize?

When an investor is looking for the proper investment, older apartment buildings in good neighborhoods often look better for a long term commitment than new construction. When a property is modernized, rents can be raised substantially and, if the work can be done without disturbing the existing tenants, the investor will not have the expense of carrying the property as he would in new construction. He would also hope that most of the existing tenants would stay and pay the increased rents, so the costs related to acquiring new tenants, as would be needed with a new construction, would be avoided.

Finally, the overall costs may be less. Although the price of the property may be high in relation to the current rents, the final cost after modernization may be far less than the cost of new construction. With this lower cost, the investor may be able to charge lower rents than new buildings nearby, putting him into a very competitive position.

When The Property Is Unproductive

Unproductive properties can present opportunities for big profits. When a building is bringing in little or no income because of obsolescence or because of changes in the neighborhood that have made the location unsuitable for the original use of the building, converting to a new use can make a new profitable income stream. As an example, a movie theatre in an area converted to industrial might be changed to a factory or warehouse. Some neighborhoods have changed from warehousing and factory areas to residential. A factory building that is no longer being used could be converted to a residential condominium project.

Don’t overlook properties that are still productive, but may have a much greater potential after a conversion. A chocolate factory was converted to a shopping center on the west coast. Movie theatres have been converted to supermarkets. Garages have been converted to condominium parking buildings. Seeing potential profits in older buildings takes imagination. ❑

Increasing Cash Flow in Apartment Properties

Increasing Market Value

Since the value of a rental property is based directly on the cash return, adding value means increasing cash flow.

When small investors set out to increase real estate values, the steps are in upgrading houses, duplexes, triplexes, etc., enhancing the cash flow and therefore increasing equity when the property is sold.

When working with larger commercial and apartment properties, there are two major actions:

- Be aware of the things that have the potential of adding value, taking advantage of this knowledge and moving quickly before another buyer can purchase or option the property.
- Do the required homework on the property. A feasibility analysis can measure the ability to add value. There may be many other measures that must be taken, such as market analyses, applications for new zoning, design and construction planning and a plan for marketing.

The Profits

Investors purchase commercial income producing real estate to make money. There are two obvious ways of making money from a property.

First, the owner takes a share of the annual operating profit generated by the investment, and

Second, profits from increasing the market value of the investment beyond what it would be because of inflation alone.

Apartment properties lend themselves to the second way of making profits better than many other types of investments. Increasing the market value of rental units does require know-how, absolute understanding of the market values of this type of property and excellent management.

The Operating Income

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 property managers will do a much better job than most owners and will more than cover their fees. ❑

Checklist For An Apartment Investment

When any particular apartment building is under consideration for purchase, there are a number of factors that should be considered. Here are some of the more important points:

- **Location** is always at the top of every list of considerations in real estate. Always check not only the building itself but also the entire neighborhood. How does this building compare with others in the area? How do rents compare? How close is a business area and is there adequate transportation? How close are schools, recreation areas, shopping and churches?
- **Rentals and floor plans.** What is the layout of the apartments and the average rent per room? How competitive is the rent level and is there any chance for increases? The rent level may not always be equal to the rental value. An apartment that is rented at a bargain price in a good community may have more rental value than high-rent premises in a declining area.
- **Condition of the property** can be the difference between profit and loss after purchase. Check the building and the grounds. What is the age and type of any equipment used? Is there any deferred maintenance? If you have checked the other nearby buildings, your building and grounds must compare favorably with the others to get the same rents.
- **Vacancies.** How many currently vacant units? Based on comparisons with neighboring buildings and past history of this building, when do you feel that the vacancies will be filled?
- **Amenities offered** to your tenants must be in line with the type of tenant. Singles might be interested in recreational equipment and a pool. Tenants with children might want play areas. Perhaps the amenities you offer will be compared more to other apartments by potential tenants than the apartment itself. Does your unit have air conditioning, fireplaces, built-in kitchen appliances and modern bathrooms?
- **The Income**. As stated, the value of the property is based on the income. While everything should be checked thoroughly, anything to do with the cash flow and expenses should be double-checked. Income can come from many sources, apartments, garages, utilities, parking spaces, coin-operated washers & dryers, or other vendors. You must see if there are any pre-paid rentals, rents in arrears, and contractual rent increases. Find out if there are any free rent concessions and be aware that these concessions may not appear in the rental agreements or leases, but in some side agreement.

The following may be a way to protect yourself from any problems with the income and possible concessions or side agreements:

A. Have the seller state in writing the rent for each unit, the terms and amounts, any concessions or pre-paid rents, any written or unwritten arrangements between the tenants and the owner or his agent. A provision can be included that these representations will survive the transfer of title and any misrepresentation found before that time will be grounds for rescinding the contract, with the buyer to be entitled to costs and disbursement incurred.

B. Verify the information on the seller's statement against the leases and against seller's receipt books. Interview several tenants to check terms of their leases against seller's statement.

C. Have the seller sign an affidavit that the statement reflects the correct rental amounts and terms, that there are no other lease agreements in existence, and that he is making the statements to induce the buyer to purchase, knowing that the buyer is relying on the affidavit.

D. Also look into the possibility of options to cancel leases and commitments for future improvements to apartments.

E. Finally, check whether the amounts that the seller has reported as tenant's security deposits are correct. Check contracts with any outside company, such as coin-operated washers and dryers to check for the terms and income.

- **The Expenses.** Examine the expense statements for past years, not just for a few months or one year. See if there could be any under maintenance, which might not be apparent in an inspection. Maintenance could have been deferred recently to improve the current net income to facilitate the sale of the property. Check the number of employees, their jobs and the total payroll, and any requirements of union contracts. Are there any rent concession agreements with employees? Can you reduce costs by better staff management?

The following items of expense should be carefully examined:

1. **The loans on the property.** Check all of the terms of any existing mortgage that will be assumed. Determine if refinancing is desirable and feasible.
2. **Real estate taxes.** Are assessments and tax rates correct? What will the recording of the sale do to change the assessment? Will the property tax change after the purchase? Determine the percentage of assessed valuation between land and improvements to see if a satisfactory corresponding allocation of the purchase price can be made to establish a depreciation base.
3. **Insurance.** Is property properly covered? Can premiums be reduced in any way? Will more insurance be required if you increase the mortgage?
4. **Utilities.** Check the bills for the costs of heating, gas, water, and electricity. Check bills on an annual basis, rather than a few months. Are there separate sewer charges? If so, how are they computed?
5. **Check all outside contracts.** There may be contracts for maintenance, separate contracts for elevator maintenance, cable TV, and exterminating.

All of these checks and investigations are part of the routine of the real estate professional. Some of the duties of the broker or brokers representing the buyer and seller in a real estate transaction are to satisfy the buyer that all of the information about the property is correct and complete. Normally, when employing the most professional real estate firms, this research will be completed by the brokers before the information is presented to the purchaser.

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

Investment Planning For Everyone

A prospective investor may have a problem getting started with a real estate investment because of the great variety of properties that are out there. They may be fearful that someone will "sell" them something – something that is wrong for them.

An answer to these problems can be an interview with an interested professional real estate broker who can act as a real estate investment counselor. Each prospective investor can be interviewed in depth to find out specific needs in an income property. At the same time their needs are being evaluated, the broker will also communicate what benefits are available in various properties and how to identify them.

Some considerations should be given to the risk of loss for each age bracket of investor. Should an older investor purchase a property with the smallest down payment and highest leverage position? This will limit cash flow and may cause the property to have a "negative" cash flow. Is this what they want – or do they want cash flow from the property?

How about the younger couple? Are their objectives for long-range estate building or for current cash flow? Would they be more willing to take chances with a marginal investment that might bring big returns later?

These answers must be decided by each investor for himself or herself. But, only after enough information has been furnished so that an intelligent decision can be made.

When a new investor has a better idea of the type of property that will do the right job for him/her, or them, then and only then should they be exposed to the market place and shown specific properties. Now the investor or investors can evaluate the various benefits and risks for the information shown on each property and apply the information to their own situation.

What is right for you? A new rental unit? A strip center? A one-hundred unit apartment property? An Outlet Center? Perhaps you should have five or six apartments or commercial properties in scattered locations. Real estate counseling can show you that you can choose which is right for you and know the reasons why it is right! ❑

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.