Cravey Real Estate Services, Inc.

A Full Service Commercial Real Estate Company

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Commercial Real Estate Investment Newsletter

Things To Look For Before Investing In Apartments

With real estate values stabilizing, apartment properties throughout the country are the most sought after rentals. Assisting new buyers with the purchase of a residential rental is the job of the commercial broker. When you are looking at different properties, we will furnish full information on existing and potential loans, income, expenses, etc., to help you make the right choice.

In addition to the financial data that you expect, we can also evaluate the physical attributes of the property, giving you suggestions on what to look for and what to avoid.

Here are a few of these tips:

- Look for properties with refrigerators in the units and with space available for a washer and dryer in a common area such as the basement. While large apartment houses use coin-operated laundry units, for two-or three-unit apartments it is better to use less expensive, standard units.
- Avoid properties with common heating, hot water and electric service. If the property does not have separate utility services, plan to separate them immediately after purchase of the property. Let each tenant assume responsibility for utilities used. When a tenant pays for his/her own utilities, they are more careful with waste.
- Be careful with wood buildings. Preferred for investment are brick, stucco, or aluminum (or vinyl) sided structures. These have less frequent and less costly maintenance.
- Avoid properties with common halls or stairs. Requirements for sprinkler systems and smoke detectors are often stringent for such areas.
- Make sure the property meets zoning requirements. A seller may try to sell an apartment property that has had a common area converted to a small rental. There may be more units rented than zoning allows. In a very small property, a seller might try to sell

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a house with a mother-in-law apartment as a duplex. If a variance in the zoning is required for the existing rental conditions, get the variance before the closing of the sale.

- Check insurance costs. Liability insurance is becoming very expensive for dwellings of three or more units. Fire insurance now on the property may not be adequate to cover the replacement value.

- Only consider a property for purchase that has rental income sufficient to cover all operating costs plus mortgages and taxes. Tax benefits in the ownership of an apartment property are less than they were a few years ago, so the income and expenses should be handled like any other business property. The cash flow should allow the units to support themselves and give the owner a return on invested capital. ❑

The Insurance Owners Must Require Tenants To Carry

Insurance coverage must be addressed by both landlords and tenants. For the run-of-the-mill daily problems, a landlord must have the maximum coverage for the building and the tenant's leases. The tenant must cover the business with coverage that will protect it. What if you have a small disaster that is easily repaired, but you lose a tenant because he was not covered for the damage inside the business?

Consequential Loss Coverage

A fire or other peril may cause a financial loss other than that resulting from direct destruction of the property. Such losses are called "consequential losses" and include those resulting from the loss of use of the property destroyed, such as interruption of business, and property loss from indirect connection with the hazard rather than from direct destruction. The types of insurance against consequential losses include:

- Business interruption insurance.
- Delayed profits insurance, which covers the loss of profits that result from a delay in the completion of the construction.
- Leasehold insurance, which covers a tenant's financial loss if the lease is canceled as a result of fire or other insured peril.

Business Interruption Insurance

A business interruption policy normally embraces both loss of income and "added expense" protection. The latter may be the more important because it reimburses the tenant for the special costs associated with obtaining substitute equipment and (if temporary space is needed elsewhere), the cost of renting such quarters. To the extent that the tenant's profits are adversely affected, notwithstanding the ability to continue operations, protection is furnished by the loss-of-income feature of this coverage.

Business interruption policies can be more effective with appropriate endorsements that enlarge the covered causes of loss and extend the period of indemnity. Two examples are the following:

- **Nonbuilding damage.** The standard policy only covers losses attributable to a casualty to the building itself. If damage extended to telephone and data service lines located outside the building, resulting losses to the tenant would be covered only under an appropriate endorsement to the policy.

- **Extended restoration.** The standard policy limits the indemnity period to the time needed to restore the building to its precasualty condition. This may be less than the time needed for actual restoration, for example, when local law requires the reconstructed building to meet updated code standards. The policy coverage can be extended for this purpose by endorsement.

Lease Termination Insurance

When casualty damage is so extensive that the landlord can cancel the lease, the tenant may incur loss because it is unable to lease elsewhere on comparable terms. Leasehold interest insurance protects against such loss. The loss is equal to the discounted present value of the difference between (1) the rental specified in the lease and (2) the higher market rent for comparable space, projected for the balance of the lease term, including all renewal option periods. ❑

Options – Great Investment Tools

An option on real estate is an extremely versatile investment tool that comes in a variety of forms that can be used for a variety of purposes. The primary use of the option is that it gives the optionee (the party holding the option) control over property (in the sense of the right to buy it) for very little cash. It gives the most leverage and conserves cash, both very desirable for investors. An option gives the holder the right to buy a specific parcel of real estate at a specified price, on specified terms within a specified period.

An option can be compared to (1) a contract of sale with a liquidated damage clause; (2) a sale with a nonrecourse purchase money mortgage; and (3) a lease containing an option to purchase.

Contract of Sale With Liquidated Damage Clause

Instead of an option, an investor could enter into a formal contract of sale containing a liquidated damage clause. This is a contract that the investor may walk away from, subject only to the loss of the down payment as liquidated damages to the seller. The advantage of an option is that it is less complicated (and so may involve less negotiation and legal fees) than a contract of sale although it is undoubtedly a better idea to attach a contract of sale to the option agreement so negotiating problems do not arise later if the option is exercised. On the other hand, a seller may not be willing to give an option, preferring a contract under which the seller retains the choice of either accepting the down payment as liquidated damages or seeking actual damages in a larger amount from the buyer.

The prospective buyer does suffer some limitation of rights as an optionee because the holder of an option lacks a legal or equitable interest in the property (whereas a contract vendee has rights as set forth in the contract).

Sale With Nonrecourse Purchase Money Mortgage

As an alternative to taking an option on property, an investor may purchase the land, acquiring legal title from the seller who takes back a standing (no amortization) purchase money mortgage equal to 100 percent of the sales price, with interest to be paid annually. The mortgage is nonrecourse (the buyer having no personal liability), so the seller's sole remedy in the event of a default in payment of the interest is to repossess the land. If the purchase is of undeveloped land and the mortgage contains a provision for the release of individual parcels, the mortgage functions in the same manner as a rolling option.

Amounts received by the seller as interest each year are taxed as ordinary income, while the purchaser may be entitled to a deduction for interest paid, subject to the tax rules regarding deductibility of interest. By comparison, annual payments under a long-term option would not be income to the seller if properly structured and would not be deductible by the buyer.

Lease With Option to Purchase

Another alternative to the use of a straight option is a lease containing an option to purchase. In this arrangement, the investor can obtain immediate possession of the property as a tenant, paying rent rather than an option fee. This approach makes sense for income-producing property. The investor is in a position to earn a return over and above the rent paid to the landlord while at the same time retaining the right to acquire ownership of the property at a future date. Rent income is taxable to the landlord as received, and is deductible by the tenant assuming other requirements for rent deductions are met. ❑

Shopping Centers – The New Town Center

Shopping centers have been changing. Increased spending power in the population is supporting new mall construction and the renovation of existing centers.

Now the newer and renovated centers are becoming more mixed use, with hotels and office buildings being incorporated into the plans. Larger malls are providing more than just shopping. We are seeing more cultural attractions, medical clinics, health clubs, spas, and other facilities locating there.

With the success of the huge mall/amusement centers throughout the country, the idea of combining amusement centers with shopping facilities is taking hold.

Shopping centers are increasingly becoming "town centers", which is what the original planners had in mind for these facilities in the beginning.

Changes and Opportunities

The idea of enclosing a shopping center came about 30 years ago. Since then there have been many other innovations. We now have super regional malls, mixed-use shopping centers, high-rise downtown centers, off-price shopping malls. More recently, anchorless strip shopping centers, centers with unconventional anchors, fashion centers, mini-malls, promotion malls, shopping center condominiums, underground climate-controlled shopping centers.

Opportunities may abound for the innovator who can make some significant changes in an older, more conventional center. We may be on the brink of a return to urban shopping. The trend could bring three problems:

1. There may be difficult times ahead for the existing older shopping centers.

2. Developers may be overbuilding new suburban shopping centers.

3. The days of the downtown pedestrian shopping mall may be numbered.

Renovation can be the answer to help minimize the hard times for older suburban shopping centers. The renovator might look at the area and ask himself what he would do if he was working with a vacant piece of property - and a new shopping facility was being constructed. He must identify his retail market. Then the existing center can be renovated with the features that will appeal to his particular market today. ❑

Curing Vacancies In Investment Properties

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, 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. Re-name the building and have the mayor cut a ribbon. Hold a block party on the grounds or in the building proper and invite the press, radio and TV stations. This is the kind of publicity that just cannot be purchased with money.
- 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.
- 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 just not have 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. ❑

Your Real Estate Investment

Knowing what you can do in some investment situations can be the difference between an annual profit or loss in your currently owned commercial property or the one you intend to acquire. How you acquire it can be important.

The professional commercial real estate broker is in the position to represent a client in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. This real estate practitioner stays aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and/or tax advisor. We always recommend consulting with these professionals during the planning and closing of major real estate transactions. All can affect taxes and estate planning.

We are the heart of your professional team, creating the real estate transactions that will be needed to expand your estate. Let's get together to evaluate your present portfolio of properties, or review your plans for future acquisition.

Starting with your present position and your goals for the future, we can set out moving directly toward achieving those goals. ❑

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.