Cravey Real Estate Services, Inc.

A Full Service Commercial Real Estate Company

Check us out on: Twitter Facebook Linkedin

Cravey Real Estate Services, Inc.

5541 Bear Lane, Suite 240
Corpus Christi, TX 78405
361-289-5168 Office
361-289-5442 Fax
cravey@craveyrealestate.com
www.craveyrealestate.com

Commercial Real Estate Investment Newsletter

Convert And Upgrade For A New Potential

One of the ways to increase income and value is to upgrade an older property. In every community, anyone who looks can usually find a number of commercial buildings, apartments or offices that need to be modernized. Some are for sale because the present owner may not recognize the increased return that they could get or do not want to make a further investment. The property might be purchased at a bargain price that is based on the current cash return.

Don't overlook properties that are still productive, but may have a much greater potential after a conversion. Factories have been converted to shopping centers all over the country. Old Movie theaters have been converted to multi-screen facilities. Garages have been converted to condominium parking buildings. Seeing potential profits in older buildings takes imagination.

When you set out to upgrade an older building, you will encounter either deterioration or 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.

March 2018

This publication is not a solicitation but is an information service from this office.

In This Issue

(continued)

Ways To Upgrade

There are several ways used to upgrade a building.

When a building is quite old, structural changes may be needed for safety reasons. Before you purchase the building, a professional engineer should make an inspection. 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.

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 an old, slow elevator to a modern one.

Aesthetic improvements are the sprucing up of the property and can usually be done at a relatively little 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 Do The Upgrade?

When an investor is looking for the proper property, 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/she would in new construction. He/she 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 her/him into a very competitive position.

Convert To A New Use

Unproductive properties can present opportunities for big profits. When a building is bringing in little or no income because 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 theater 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 or a shopping mall. ❑

The Land Under A Business–The Most Valuable Asset

Anyone who owns a home that was located in a hot housing market a few years ago knows that the land can be worth more than the actual home. Now many companies are figuring out the same about their own real estate holdings.

Many entrepreneurs spend their adult lives building a business up so that it can be sold at their retirement or passed down to their heirs. Now many of them are finding that the land under the business is worth far more than the business itself.

Major retail firms are in this category. A lot of companies will be more attractive for their hard assets than their actual sales, particularly during a recession.

The Lessor's Benefits

When land values soar, strategies must change. An example could be the developer of upscale homes who wants to keep the ownership of the valuable land as an investment. The use of the land lease can widen the market by reducing the purchase price of the house. In certain parts of the country, the value of the land equals the value of the house. Leasing the land can cut the purchase price nearly in half. With this type of land lease, there is usually a provision for a rent increase halfway through the lease term in accordance with the results of a reappraisal of the land.

The Lessee's Benefits

The land lease results in the following benefits for a

(continued)

builder or developer:

1. She/he can acquire a valuable parcel of land with very little cash investment.

2. This leasehold that is acquired is an asset that can increase in value, and then could be used as security for a loan, or could be sold for a profit.

3. The rental payments are fully deductible by the lessee. If he/she had purchased the land instead of leasing it, only the interest portion of the payments would be deductible.

4. With a subordinated land lease, the lessee-developer gets the equivalent of a 100% loan on the land.

Land Rent and the Term of the Lease

Usually, a developer-lessee will attempt to get the longest possible term in the lease because the shorter-term land lease would have a smaller market for resale. A long-term land lease is generally a net lease under which the lessee pays the carrying costs, including real estate taxes.

When the land rental is a fixed amount, it is a percentage of the fair market value of the land when the lease is executed. This lease will often include a provision for reappraisal of the land at fixed intervals, with new adjustments in the rent. In some cases, for instance with a shopping center, the landowner might demand a share of the percentage rentals over and above the fixed land rent. (Much of the income in the shopping center will come from percentage overages from the sub-lessees.)

A Subordinated or Unsubordinated Lease

If the owner of the land will not subordinate the lease to a leasehold mortgage, the developer should get a reduction in rent because the unsubordination will cause his or her financing to be more expensive. Subordination could be the most important item in the terms of the lease. Even a short subordinated lease might be better than a longer unsubordinated lease, even though the longer lease is more salable.

The landowner may or may not allow the interest as owner-lessor to be subordinated to the interest of a leasehold mortgagee. When there is a subordination to the mortgage, the lender, in effect, gets a fee mortgage on the land rather than a leasehold mortgage.

When the lease is unsubordinated, the landowner-lessor has first rights over the lender in case the lessee-mortgagor should default. With these terms, the lessee could find that he/she cannot get a loan, or can get one only at a higher rate of interest. Without the subordination, the mortgage is, in effect, a second lien since the lessor's claim on the rents takes precedence over payments on the mortgage.

The objections of an owner to subordination of the lease could be as follows:

1. He/she could lose the property if the lessee defaults on the leasehold mortgage.

2. Subordination reduces his or her possibility of mortgaging the fee interest in the land, which would be a logical move for the lessor.

If the subordination were part of the terms, the landowner would record the right to receive any notice of default from the leasehold mortgagee and the right to cure the default. The expense would be reimbursed to the owner by adding the amount to the lessee's rent obligation. ❑

Considerations In Ground Leasing

Landowners may choose the ground lease as a way to benefit an easy and risk-free investment vehicle and as a way to secure the long-term appreciation of the property. Sometimes a ground lease can put the lessor at risk. That is because the deal centers on the concept of sharing economic returns. The lessor becomes a partner of the lessee because the total rent is usually determined by the lessee's net operating income or net cash flow. If the lessee does well, the lessor does too. However, if the lessee's business is a loser, so is the lessor.

Therefore, the lessor must consider the financial feasibility of the project. Independent analysis should show that the project represents the correct improvement of the site and that the projected payments will actually be received by the lessor.

There are at least four things that a prospective land lessor should remember before entering into a transaction:

- In most land lease transactions, the economic return to the lessor ultimately reflects the underlying performance of the real estate operated by the lessee.
- The lessor's evaluation of the deal must focus on the quantity of income projected pro forma but also must include a clear assessment of the likelihood of actual receipt of projected rent.
- Because the conditions and complexities of a land lease can mask the risk associated with achieving the projected rent levels, accurate assessments of the strengths and weaknesses of the real estate is essential.
- Land lease provisions must be tested against the current fee value of the land. ❑

Restructuring Troubled Property

In any market, good or bad, there are always problem properties. Most are only troubled or problem properties because of the current ownership. Some may be neglected only because the present owner has failed to do fairly simple things that can solve the problems. Buying property and solving problems is a profit-making business.

Have you seen: An empty office building. A remodeled apartment house or hotel that has an excessively high level of vacancy. A large tract of undeveloped land that no developer has become serious about wanting to develop. These are examples of troubled property–property that is a definite financial burden to continue to hold but which also is unattractive property to some prospective buyers. Unattractive, that is, until very recently.

The timing now seems right for investors to obtain troubled property. The pressure on owners and lenders with troubled property to get out from under the on going burden is also high. The result is that syndicates have been formed to seek out and buy up troubled properties.

High Risks Not For Everyone

Knowledgeable property developers and managers (especially those familiar with empty or near-empty office, hotel, and apartment buildings) caution that buying troubled property requires taking a very high risk. The financial returns are uncertain and may be a long time in coming, if they come at all. This type of investment is not for everyone; it's for those who can afford high risk situations.

The profits can come from any one or a combination of circumstances.

- A market turnaround caused by a boom in the local and/or national economy.
- An improved system for promoting and operating the property. Some syndicates are being formed solely to manage the troubled property with an option to buy when and if it hits a specified profit level.
- Purchase of the property at a bargain price, often combined with imaginative and untraditional financing techniques. Some lenders are asked to share the financial risks by accepting a low initial interest rate in return for a big share of the profits later on. Sometimes the seller of the troubled property is asked to retain a financial stake in the property and to help turn it around. The seller's experience and involvement in the project from the start can be valuable.
- Including the troubled property in a larger development plan. An office building that sits empty might become part of a new industrial park with hotels, conference facilities, and residential apartments, all of which are successful.

Take another look at troubled properties in your area. With fresh new ideas and a re-structuring of the mortgages, the troubles may go away, leaving a profitable investment for you. ❏

Commercial Real Estate Representation

There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. A professional real estate practitioner must stay 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 CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

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. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. ❏

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.