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Commercial Real Estate Investment Newsletter

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

In This Issue

Good Management For Apartments–More 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.

Management and 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 administrative hardware and software.

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

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. ❐

When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

Decision To Lease Or Own Commercial Property

Whatever the kind of property used, the user has the option of purchasing or leasing. Should you buy the house you live in, or lease it from someone else? With few exceptions, there would be an overwhelming response to "own it." The benefits weigh heavily toward ownership. With business property, the answer sometimes may be a lease instead.

Real estate investors who enter into a long-term lease instead of buying property make a decision with implications that can have an effect on both financial and tax positions. The important difference of the long-term lease from a straight purchase (outright or with a loan) is borrowing (renting) the property itself for financial benefit. Payments for the use of real estate can be beneficial, with lease payments fully deductible expenses.

Sometimes the choice of owning is not available and the property can only be leased not purchased. During a period of time when money is not available except at very high rates, leases may be the only consideration. Another time when only leases are practical could be with the best possible location in a large city, where institutional owners hold the land on a long-term basis.

Here are examples of some property users who must make this decision:

1. Some real estate users have a prime objective of maximum cash flow now, in commercial or residential income properties. They will be interested in securing capital, investing for maximum return.

2. Any store chain, fast food outlet, other franchise operations must use real estate in the operation. Should their money be used to purchase property for their locations or be retained for working capital and expansion?

3. An owner wanting the highest leveraged position, with the greatest interest in securing the largest gain possible from the property. This owner could avoid tax liability on current income from the property.

Property used in Trade or Business

With a new business, the owner of that enterprise has the choice of buying or leasing the business location. In the beginning, this choice has little meaning to most. The owner most often will lease a business location, preserving capital for operation of the business. Capital is always critical in early operations and is seldom in enough supply to purchase real estate.

A Later Choice

The choice of buying or leasing remains as an alternative even later. After some years and much success, the owner may wish to expand, change locations, or just have a business location that is "tailored" to the specific needs of his operation.

So, the business owner buys a property with a small down payment. He borrows and builds a building, which is perfect for present and future needs of the business. In addition to the best location, there are other benefits that might help to make the decision to purchase the property. These are:

1. Like a home, the owner has the security of owning the property, and the peace of mind of knowing that no one will evict the business at some later time.

2. The new improvement (building) on the property is a depreciable asset and so provides the added benefit of tax shelter for current income from the business.

3. The interest paid on the loan is a business deduction. The difference, the amount paid to principal, builds equity in the property.

4. The ownership of the real estate gives the owner a stability and added stature in the community, increasing his financial strength.

Now, in addition to security and self-image, the owner has all of the elements of a good "leveraged" investment: Low down, large loan and depreciation of the improvements. The cost may have been fairly small. After a minimum down payment, the payments on the loan may not have been too different from the previous monthly lease payments.

The Next Buyer

Still later, the picture changes again. After using the property for ten or fifteen years, this owner might be approached by a broker with a buyer for a good property to own as a passive investment. The investor prefers a commercial building with a good tenant and a long-term lease. The broker suggested a purchase of an existing business property from the present owner who might then lease back the property.

The big change for the business owner happened over the years. Because of inflation in those years of ownership and the annual reduction of the mortgage with the loan payments, he has built an enormous equity in the property. The original down payment has now grown to a huge equity – maybe hundreds of thousands or millions of dollars!

The New Benefits

The purchase of the property was an excellent move for the business owner, when it was done. Now, with the passage of time, his position has changed. When discussing this with his Real Estate Investment Counselor and CPA, the following list of benefits for the sale of the property, then a leaseback, were developed.

1. The hundreds of thousands of dollars (or millions) of capital tied up in the real estate ownership would be released for expansion of the business, operating capital, investments, personal use or retirement.

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(continued)

2. The business owner's balance sheet could improve. The amount of the current real estate loans would not show as a liability and the cash would increase the asset side.

3. The seller still has the use of the original building, built to the specific needs of his business, but now it will be with a long-term lease.

4. The rent paid on the building after the transaction is deductible as a business expense, just as it was when the business first started.

5. If the proceeds of the sale are invested, the annual return may equal the rental payments on the lease, in effect making the rent on the property free of out of pocket expense.

6. The cash will be received by the seller without any loan approvals and does not have to be paid back.

7. After the sale, if the business owner reserves the right to sublet the real estate, he may be very flexible on future plans to sell the business or continue to operate it.

These benefits were all to the liking of the business owner. The only drawback was the tax to be paid on the gain in value. After his CPA computed the actual amount, the tax was minimal compared to the benefits, so the sale, then leaseback was completed.

Deductions

The sale-leaseback often accomplishes more for the seller than getting money by borrowing on the property. The seller is entitled to deduct the entire rental payment as a business expense. On a loan, only the interest can be deducted.

So, the sale-leaseback, in effect, makes the cost of the land depreciable. With a mortgage, the mortgagor can neither depreciate the land nor can the portion of the loan payment that amortizes the land (loan reduction) be deducted. Since the payments on rent are similar to principal and interest payments on a loan, this means that all of the monthly payment (rent) is put on a tax-deductible basis. This may more than compensate for the loss of the depreciation deduction, which was only on the improvements. ❐

Acquire Loans On Vacant Land

The conventional lenders, banks, savings and loans and similar institutions may slow their funding of the more speculative projects. However private lenders do make loans on land. They will usually loan on land that is intended for early development and will limit the term from a minimum of one year to a maximum of three years.

Many lenders are concerned about the flow of capital into real estate development, noting that more money is chasing fewer good deals. With the real estate recovery underway, opportunities may be returning to a previous normal.

Here are some of the considerations for this type of loan:

- **Loan to Value Ratio.** First mortgage land loans may be made for up to 50 percent of the value of the property as determined by an independent appraisal. If the borrower can put up additional collateral, the loan-to-value ratio might be increased by an additional corresponding amount. Where an existing first mortgage already exists, some lenders will consider taking a junior position, but the total of both loans will not usually exceed 50% of total value.
- **Interest Rate.** The interest rate on this type of loan will be high. Sometimes state usury laws applicable to individual borrowers can be violated. The borrower must be incorporated in this case. See attorney for assistance.
- **Amortization.** Typically, vacant land will produce no cash flow, so amortization is not required.
- **Release Price.** The owner of the land is commonly given the right to obtain the release of a portion of the premises from the mortgage lien (so it can be developed and sold) on payment of a larger-than-pro-rata portion of the loan, e.g. 125 percent or more of the ratio of the value of the released premises to that of the whole parcel. This is a form of amortization and increases the security on the remaining portion of the land.
- **Personal Guaranty.** This can be required, depending on the transaction.
- **Developer's Strength.** The experience, reputation, background and financial stability of the developer is very important. A developer with a history of success in this type of project will go far in justifying the requested loan.
- **Demand.** Existing demand for the planned development must be proved. This may require a market analysis by outside experts.
- **Type of Improvement.** A "location-oriented business" such as a bowling alley, motel or restaurant may not qualify the land for a loan, whereas an apartment or office building may do so because of the stability of the rental income once the building is completed. ❐

Obtaining The Land For A Project

Acquiring land for development is necessary no matter what kind of market we are in. Professional real estate assemblers are always looking at and acquiring under-utilized sites within cities or in suburbs. Here are some ideas on how those professionals do it.

- **A Thorough Knowledge.** Only purchase or option property in well known localities to reduce the risk of unexpected surprises. If the locality is not familiar, seek out local professionals for their opinions.
- **Be A Follower.** Being the first to buy increases the risk of being wrong and may mean an unexpectedly long wait until values rise. It is often better to go in after values have begun to increase or after some development has started.
- **Government Maps.** Local governments often have maps and plans for projected roads and highways. These can point the way to desirable acquisitions.
- **Prepare An Acreage Map.** The map should show the ownership of all tracts in the locality and (if known) the asking price of each. This step marks the prime difference between the professional and the non-professional land acquirer.
- **Seek Out Builders.** Try to find a builder willing to let you act as an intermediary in acquiring land.
- **Option Or Installment Contract.** When acquiring property, get a firm commitment from the landowner without the buyer having to pay out cash. This can be done either with an installment contract under which the buyer can pay interest only for the period of years with a right to walk away without further penalty.

Note: An investor or investment group retained by a builder to find land is obligated to give the builder the first opportunity to buy in all cases. However, any land the builder does not want may be a good investment for the assembler since its value is likely to increase as new construction occurs. ❐

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. ❐

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