How to Invest in Commercial Real Estate

By Donald Teel – Commercial Properties Northern Arizona

Everyone, everywhere, is talking about the real estate market. Even people who do not know anything about the real estate market are talking about the real estate market.

Understandably, much of the discussion remains negative. After all, the net value of all commercial real estate in the United States has plummeted by more than 20% since 2006. I would like to address the other side of this very ugly coin.

As we come to the end of 2009, how can we successfully invest in commercial real estate?

Many small to intermediate investors have been discovering that buying was the easy side of commercial real estate investment coin… the shiny side! Managing and turning properties in the volatile environment of 2009 has proved to be the tarnished side of our coin.

With respect to the fundamentals of investing, nothing has really changed. Yet, we all know, much has changed and continues to change, especially with respect to the acquisition and cost of capital and sustained value. For the purpose of this article, I would like to place a market spin on what I think are the 10 most important principles for small commercial real estate investors to follow in 2010 and beyond.

Property Type. Who could have predicted that the multi-family sector would be where it is today based upon our assumptions ten years ago. We must remind ourselves that our assumptions are merely momentary conclusion based upon ever-evolving data and that the moving data is almost always something over which we have most likely, no control.

Type-casting isn't just a Hollywood phenomenon, it's imperative with every real estate transaction these days and in the case of multiple tenant revenues each lease will need to be sifted and ground down in order to determine its viability and value going forward. There are "leases" and there are "Leases" and there are "**LEASES**." Nothing works well if the tenants don't!

Inventory, absorption rates and occupancy rates and CAP rates are imperative to the investment equation. There is no negotiating these issues and they are deal breakers.

Still, it's Location. The newest and perhaps safest strategy for small to medium investors is to get big by investing small all over. Just as mix of property types is essential to a sound investment strategy, so also is the principle of multiple locations based upon regional economic dissimilarities. Atlanta's medical office values and projected demands will be different than those of Seattle and it

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would be ridiculous to compare Phoenix multi-family to say, Manhattan multi-family.

Within macro locations, there are micro locations and micro product. For example, if one really must invest in multi-family in Arizona, it would be wise to see investments with 4-8 tenants, under $2 million and perhaps not in the dense market of metro Phoenix but perhaps in central or northern Arizona communities of Prescott, Sedona, Payson or Flagstaff, since these markets are more self- contained.

Sound commercial investment thinking must go beyond the local to the national and even, when qualified and warranted, an investor can think international.

Commercial investment is about the cash flow and it is the cash flow that will ultimately determine the investment property value.

The Pace of Personal Risk. Too much, too fast is what I saw occurring from 2000-2006. Investor appetites were often out of control, money was easy and many believed the returns were going to be sustainable. Not so, we all know now! The pace of investment, especially where the investor is relatively new to commercial real estate is sooooooo important. It's advisable that a new investor look at one property every 18 months for three years, as a basic formula. There is just too much to watch, more to know and the risks are greater than at any other time in history.

A partnership buffer can help with personal risk. It's not advisable to put all of your eggs into one basket and it is less than optimal to do so alone. It looks like partnership are becoming more attractive to a lot of previous Lone Rangers who are now mortgage heavy and cash light. On most properties I have owned, there has been a partner behind me, beside me and in front of me and it always helped with both risk balance, capital demands, mortgages and in the end divestiture.

Going slow and not going slow alone is the new formula for smaller investors.

Demand Analysis. I have watched many small investors purchase a property with limited or no demand analysis. Demand analysis looks at the next owner who will step in at year 5 and it looks at the numbers that can indicate current and future user demand.

Questions to ask might be: Who wants the property today and why? Who will want it tomorrow and why? Who are today's buyers and why? Who will be tomorrow's users and why?

I have never been fond of Las Vegas and I am not a gambler. Dice and I don't mix well and cards are even worse. Slot machines emanate noises that frighten me. Gamblers eventually fold and there is really no place in commercial investment for risky speculation. Demand analysis can minimize some of the crap shooting that became all too inherent in real estate investment during the first decade of the 21st century.

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Earlier in this piece, I talked about inventory and absorption rates. In many cases, investors completely ignore these trend lines and make investments solely on attractive CAP rates at the time of purchase. Understanding the demand cycle past, present and future will tell you a lot about an investment and give you some comfort that tomorrow's market will serve your interests.

Ask Vs. Bid Strategy. The spread is everything. Spread forms the initial basis and our capitalization model should strengthen it further. We are seeing an incredible amount of stress regarding what owners say they must sell or lease for and what smart buyers are willing to risk. The ask value is no longer valid when risk is high. What an owner paid is almost irrelevant to today's informed investor and nothing is worse than extremism on both sides of that negotiating equation.

During the past year, more than ever, I have heard buyers talk about things like "we need to adjust our offer (bid) in a way that we are protected for 36 months in case the market continues its decline. Buyers are bidding with a calculator set, not to the appreciation, but rather to depreciation. Buyers are actually betting on losses!

The ask vs. bid spread creates a huge set of psychological negatives in a transaction and traditional lenders are taking hard and long looks at the projected appreciation based upon property actuary tables, the life cycle of performance.

Better than half of all small to medium sized commercial property owners have seen more than a 25% decrease in their property values. This is disrupting lease values, tenant negotiations and ultimately the asking price.

Crafting (another work for Brokering) the transaction involves a lot more patience and skill with respect to coaching the competing interests of the Asker and Bidder so that there is a reasonable expectation of a meeting of the minds. Tilting the transaction to one side or the other can lead to serious financing problems, not to mention ROI issues. An owner who asks too much attract buyers who offer too little. In the end a good commercial transaction will be empirical, not emotional.

Creative Capitalization. Risk is always a function of the market conditions and the cost of capital or, I might say the "capital plan." These days, I am becoming a big fan of creative capital sourcing, i.e., partnering the capital requirement through partnerships and other structures including, LLC and Sub S corporations (see your legal and tax advisors for input).

The lending streams are parched and institutional lenders are increasingly favoring stronger partnerships that can personally and severally guarantee. However, there are other capital marriages that can include down payment partnerships that provide a down payment partner with
30% interest in a single asset commercial LLC in exchange for a 20-25% capital requirement. Today's numbers need to look very good and provide 12-15% cash-on-cash return. In addition, the exit strategy must be rock solid at the end of a 3-7 year model and will most likely need at least one round of new

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financing.

Shifting or spreading risk is a good way to think. Formation of partnerships, joint ventures, LLC and corporations that involve multiple players is what I call creative capitalization. Do not over-leverage a property just so you can buy it. In fact, never over-leverage.

Management. Property management for small and medium sized investors is a much larger factor than is admitted. The value of maintenance, attention and presence can create substantive value increases to an investor. Yet, many smaller investors have attempted to manage property without management services. This is almost always a mistake. Professional property management services have been known to hold value and in some cases protect owners from factors that can destroy return.

Property Management can be the eyes, ears and sense of touch and taste for a small investor and the cost of management should be rolled into the performance analysis.

A simple rule to follow is that if you do not have to manage your own investment, do not attempt to do so. The marginal savings will not be worth the effort. Typically, if a small investor has more than 4 units to manage or more than a $300,000 investment the management should be placed in the hands of trained Certified Property Manager.

Let me remind you that bad management can also contribute to the decline of property value and selecting, reviewing and correcting property management is a part of the investment model.

Reserve Resources. Capital reserves are as valid for the $200,000 investor as they are for the $15,000,000 investor. In fact, the stakes may sometimes be higher and the risk ratio more dangerous for small investors who do not create and maintain capital reserves as a part of the investment formula.

Capital reserves are something your Broker can assist you with and a factor in property management analysis that helps owners manage for the long term by having funds available for those pesky, yet often expensive "surprise" capital requirements.

One of the key reserve resources is adequate property, casualty and catastrophic insurance, including, when necessary, flood insurance. In addition, a percentage of cash flow should be allocated to a capital reserve account, monitored by your Property Management Company.

Air conditioning, heating, parking lot surfaces, roofing, glass, pools, common areas and other expenses can destroy property value and place capital demands on an owner that are unsustainable. When you invest always, always… let me say it again, always creates a capital reserve analysis commensurate with the property and make the property performance fund these reserves.

Reserves can also be in the form of personal wealth or lender commitments. The principle is a simple

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one; if you are a commercial real estate investor, you WILL need a source of capital funds and having access to capital can serve as a hedge against the market. Survival can sometimes be dependent upon having access to affordable funds.

Holding and Folding. There is that popular country western song with the lyrics, "you've got to know when to hold 'em, know when to fold 'em" that has as much wisdom as it does rhythm. Knowing when to hold and when to fold is a skill, not just an impulse. This skill is true not just in the game of poker, but in a commercial real estate investment model as well.

Many investors who were advised to "fold 'em" waited too long. They should have sold when advised to do so by their Broker but they refused to do so and now they hold properties that are highly devalued in the market.

There are many rules to follow when holding and folding and each property, its location, the objectives of the owner, market trends and the availability of financing all play a role in determining when it is time to sell and walk.

Pay attention to trends. Study the trends. Know the trends. Especially important to the hold-n-fold tension is your knowledge of capital and lending trends. These are often ignored in favor of market analysis. Capital markets are often ahead of broker analysis of market trends. Lenders are typically a cycle ahead of the market and therefore knowing when to hold and when to fold is largely a function of lending strength and the availability of affordable financing.

Let me say one more thing about this subject. If you have a property that is free and clear and the leasing trends are in a downward spiral for that property type, it may be best to fold and carry back the financing for as long as you can in order to offset value losses created by market declines. If you can be the bank, be the bank.

Rotation, Rotation, Rotation. Exchange rules are not such an easy game to play today; however, exchanging property is a key fundamental to building long-term wealth. Once you are in the game, it is not so much about location, location, location as it is about rotation, rotation, rotation.

Flipping property by means of tax deferred exchanges should be built into your investment plan and model at the time of your first purchase. The key to this is that sales are taxable events in the eyes of the Internal Revenue Service, while 1031 exchanges are not immediately taxable events.

The 1031 tax deferred exchange is an IRS approved model for selling one "qualifying" property and from the proceeds acquiring another property of like kind within an IRS approved length of time. The transaction of selling and re-investing is treated as an exchange and not as a typical sale where capital gains are taxed.

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Property rotation under the IRS rules of exchange is the most lucrative long term method for building wealth through real estate investment. There are specific rules and processes that must be followed for rotating in and out of properties, but a qualified Broker or what is known as an "Intermediary" can explain those rules to you.

With each investment, we must ask ourselves the questions, "When will I sell?" and "What will I do with the capital… pay taxes or, invest again to increase your wealth?"

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