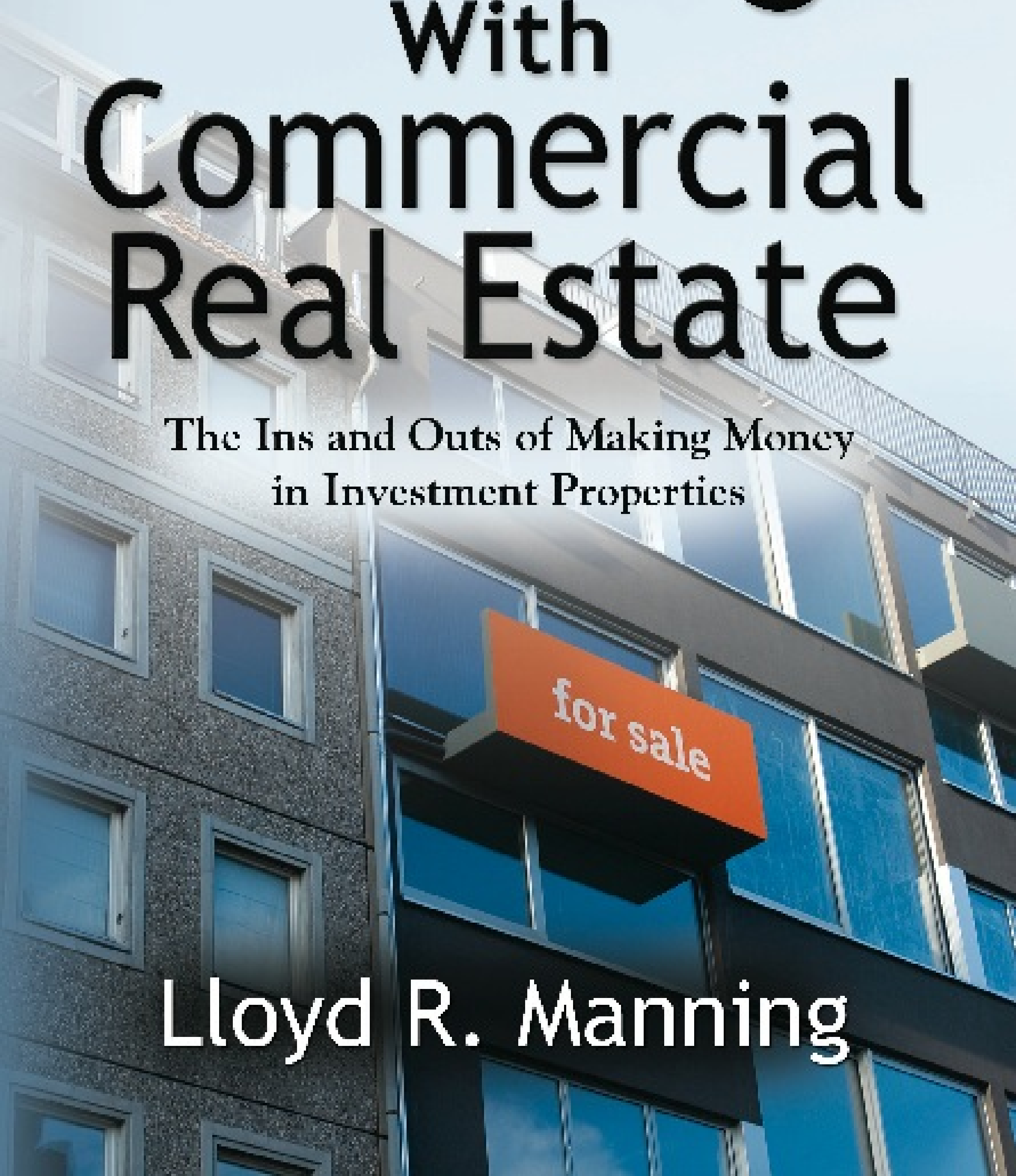
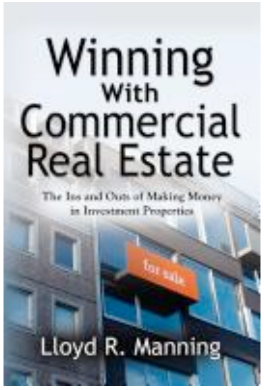
Winning With Commercial Real Estate

The Ins and Outs of Making Money in Investment Properties



Lloyd R. Manning



For novice and seasoned investors alike, this book shows how to make money in investment, commercial and industrial properties. It delves into investigating prospective opportunities, valuing, analyzing the financial statement, buying, financing, leasing, managing, reselling and much, much more. Chock-full of real life examples and checklists, provided is a comprehensive guide on how to separate potential winners from those sure to fail.

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CHAPTER THIRTEEN:

Picking the Developed - Property That Fits

There is no such thing as the right or wrong type of investment property. So much depends upon the investor, her personal likes, dislikes, objectives and constraints. What might be ideal for me may not be for you, and vice versa. Below we outline of some of the principal types of commercial properties. All other properties, developed and undeveloped, are essentially more of the same. An investment is an investment, no matter how you shape it. Before contemplating this or that type, keep the following important factors in mind:

- Your motives for investing in anything
- The amount of money that you have to invest
- The amount of risk that you are willing to accept
- The amount of time that you are prepared to devote to property selection
- The amount of time that you are prepared to devote to leasing and property management
- Your interest in real estate development, whether you prefer to buy or build
- The constraints that limit your choices

APARTMENT BUILDINGS

Residential apartment buildings are probably the most popular form of investment real estate, possibly because they provide shelter, one of the necessities of life. They hold a high level of attraction for the smaller investor as they come in all sizes, locations, with differing equity requirements and are easier to acquire than most other types of income-producing properties. In most North American cities, up to

40% of all people live in rental units. From an investment perspective, apartments provide cash flow, equity buildup through mortgage paydown, inflation protection and tax shelter.

Types of Apartments

Townhouses: These usually consist of 2 or 2½-story buildings with several apartments per building, in a row or back to back, usually randomly scattered around a larger site. Some of the newer developments, particularly senior citizen condominium or co-op complexes are single story only. Each dwelling unit is separated from the next by a basement floor to roofline party wall. Features are a semi-private front and backyard, often concrete parking pads and at times attached garages.

Walk-up or low-rise apartments. Usually 2 or 2½-story wood frame buildings that offer from three suites per building, one on each floor, to seldom over 40 suites in one structure. Apartments are usually a mixture of studios, one and two bedroom units with central heating, at times air conditioning, in-house laundry facilities, storage facilities and a common outdoor parking lot. Suite entrance is usually from a common hallway. These buildings are usually lower cost structures with a minimum of amenities, requiring a high level of management and maintenance.

Mid-rise apartments. Usually from four to ten stories, concrete or steel frame, brick or block exteriors, elevators, common hallways, central heat, air conditioning and may include amenities such as an exercise room, common meeting room, balconies and underground parking. Suite mixture is the same as other apartment buildings—studio, one-and two-bedroom units. Buildings of this type can range from medium quality to super deluxe. Number of suites per floor can be as low as one, but can go up to six. Double and triple banking (constructing two or three buildings side by side) is common in metropolitan areas.

High-rise apartments. In all respects, size excepted, these are the same as mid-rise apartments. Heights range upward from 10 stories, but could reach 40 or 50 stories. They usually contain several elevators, larger foyers, more amenities and always underground parking. Many of these building have 24-hour security and in-house commercial and recreational facilities. It is not uncommon to see the first few floors of these structures occupied as office buildings.

What to Look For

When you get into the residential renting business, even if you limit yourself to single family detached or duplex housing units, you need to pay particular attention to:

- **The market area.** Competing apartment projects
- **The economy of the area**. Principal places of employment, economic trends, changing neighborhood use patterns, etc.
- **Demand factors**. Sources of tenants, where they work, what they do, incomes, family size, neighborhood amenities
- **Quantitative and qualitative demand**. The number of units that can be feasibly absorbed during a given time frame, rental levels, overall condition of competitive properties, demand for specific types of dwelling units, latent demand
- **Supply factors**. Construction activity, inventory of vacancies, new projects coming on to the market or proposed, saleability of properties, mortgage defaults and foreclosures
- **Availability of financing**. Is this an area where mortgage companies would prefer not to go?

Before Buying Apartment Buildings

The guidelines set out in chapter 5 for buying the property apply to apartment buildings as well. There are, however, some specific steps to take when considering this type of property.

- **Inspect the building in a logical order.** Start from the outside of the building, at ground level, and work inward and upward. Check the foundation, exterior walls, wall cladding, decor, doors, windows, balconies, soffits, etc. From the inside, start with the bottom floor, the utility and storage rooms and work your way up to the top. Finish by looking at the roof. Often it will not be possible to see all of the units if it is a larger complex, but be sure that *you* and not the manager or tour guide make the random selection of what apartments to see. Check a few of each type and be sure to inspect some corner suites. Moisture or condensation problems or cracking will normally show first in the corners. Do not be afraid to open the doors of ranges and refrigerators to check for poor condition or if they need immediate replacement.

- **Compare the rental roll with the actual occupancy.** Some landlords insert revenue into the rental roll when they really have vacancies. Some rolls start off with actual collections, others with potential revenue and then insert an allowance for vacancies or nonpayment. Make sure that you end up with an accurate figure of what the revenue is, who pays, who does not and the situation on arrears.

- **Confirm operating costs.** Owners and managers have the greatest opportunity to "fudge" numbers with this balance sheet. Never assume that you can operate more efficiently than the present owner. You may not be able to. If you plan on doing the repairs, maintenance and janitorial work yourself, be sure to include this as a cost on your pro forma income and expense statement. Only this way can you truly measure the return on the investment and compare this property with any other. At the same time, if you plan to live in a unit yourself, include in the income statement the rent that you would normally get from a third party.

- **Develop a pro forma income and expense operating statement**. Include the cost of bringing the building up to a 100% condition.

- **Check the fixtures and equipment.** Especially in old buildings, ensure that the heating, electrical, plumbing, fire safety, fire escapes and all other matters come up to the required building code.

- **Study the deposit records**. If landlords retain security deposits and have to spend a large amount on repairs, this may be a tip-off as to the type of tenants you may have. (Keep in mind, however, that some unscrupulous landlords raise money by not reimbursing deposits. Their illegal behavior may not be a reflection of the type of tenant who lives in the building.)

- **Plan for the distant future.** When you buy an apartment project always keep in mind that someday you will want to resell. Doing the background analysis is ultra important. You may want to condominiumize the building in the future. Is the building suitable? If not, look elsewhere.

Apartments as Investments

On the whole, apartments can be profitable investments if you are selective before buying. In most cities, even when there are no rent controls, cash-on-cash return on investment is not as great as for many types of commercial real estate. As equity builders, apartment buildings are among the best options, but for flipping, among the poorest. What apartments require most of all are hands-on management and TLC. Except for the very large buildings that have on-premises management, this is not an investment for the absentee owner. There are too many things that can go wrong—a roller coaster market where you can be full one month but 50% vacant the next, too much potential for renting to people that will not pay and will damage the units, and so forth. If you can buy a medium size property, live in it and do all of your own maintenance and repairs, residential apartment projects rank among the better investment properties.

SHOPPING CENTERS

The Urban Land Institute defines a shopping center as "a group of commercial establishments, planned, developed, owned and managed as a unit related in location, size and type of shops to the trade area it serves; it provides on-site parking in definite relationship to the types and sizes of the stores."

The basic characteristics include:

- A unified architectural treatment
- A unified site, paved and well lighted
- An accessible location from its market area
- Sufficient on-site parking for customers and staff
- Interrelated tenant grouping, retail stores balance
- Comfortable surroundings, a safe environment
- Customer convenience

An Overview

The shopping center presents an excellent example of the ever-changing process of retailing and the retail store. Today's superstore evolves from ancient times when traveling caravans sold merchandise from tents or set up shop on dusty streets in some Arabian oasis. It is estimated that at this time there is over 12 sq. ft. of retail space for every man, woman and child in the nation.

While the total number of stores is declining each year (secondary outlets in many malls excepted), the average store is generally becoming larger and more diversified. Food markets and drug stores are excellent examples of this trend. Not that many years ago 10,000 sq. ft. was considered a supermarket. The mega-stores now being built are between 75,000 and 200,000 sq. ft. each. Projections for the near future suggest that the hyper store, the next step in this continuing evolutionary process, will be over 250,000 sq. ft., all on one floor and under one roof.

The next generation of retail stores will offer a still greater selection of goods, and each will have a decreasing amount of floor space devoted to their principal line, be it groceries, hardware, drugs or whatever. For example, traditionally, a drug store sells 45% of its sales in the pharmacy and 55% in what is known as the front of the house. These are cosmetics, toiletries, over-the-counter drugs and paper goods. As drug stores go the super store route, each year the pharmacy volume becomes a smaller percentage. Customers must now wade their way through pots and pans, appliances and auto supplies to find the pharmacist. In the modern supermarket, approximately 60% of the floor space is taken by non-food items. This increasing trend toward diversification into non-related items will continue—drug stores carrying hardware, food markets carrying dry goods and tire stores where it is difficult to find the tires.

At the same time the small store selling staple items or catering to a specific clientele remains, and all indications are that it will continue to remain. The supers claim to provide the most efficient shopping experience for the value-conscious, one-stop shopper. On the other hand, small convenience stores that provide a compatible level of price and service continue to grow. Each year they post increasing volumes and profits.

In many malls or cluster shopping centers the anchor tenant is not what it used to be, its role being gradually diminished. The sales per square foot of most department stores is falling with many having financial difficulties. For the most part, their losses are the gains being realized by the supers. Several are reducing the number of outlets by abandoning locations, some reducing space per location, with still others disposing of entire departments or operating divisions. Yet the owner of shopping centers is still expected to give the department store rent at less than cost. The difference is made up by the higher mark-up specialty shops that occupy the other mall spaces. There is an increasing movement to end the anchor tenant's subsidy, which now is at the expense of the smaller or secondary stores. In the future this will be a more measurable trend, well worth watching.

Retailing is a growth industry. Although to recite statistics is beyond the purpose of this exercise, it is interesting that even in times of recession, the major chains post still higher sales and for the most part greater profits. However, this is offset by the continuing demand for a greater variety of goods and a higher level of service. Retailing is also a bi-directional industry. On the one hand, more super or mega-stores and malls are being developed, yet on the other, the universe is decreasing in number with more concentration in smaller specialty shops. Some sectors of the industry are becoming more prosperous while others are sliding backward. The independent or small-town country stores are a dying breed.

Due to the high cost of land, with most of the good sites already taken, the big push in many communities is for urban renewal. Accordingly, the future will probably incline more toward rehabilitation and modernization rather than new development. This will be particularly true of the smaller stores and shopping centers, particularly the neighborhood strips.

The structure of the current leasing procedure will change. Leases will be structured on more of a partnership basis, replacing the prevalent payee/payor relationship that now exists. More partnerships or share agreements will be structured. A greater fiduciary relationship between property owner and store operator than presently exists will become the practice, not the exception.

In summary, the next fifty or so years will bring as many changes in the retail industry as have the last fifty, perhaps even more. All these considerations tend to obscure the projective and analytical capability of the prudent investor. An often confusing situation becomes still more uncertain. To survive, the landlord will have to be aware that the old rules and the old methods will no longer apply.

Retailers and shopping center owners of the future will require uncanny vision or excellent balance sheets or both. Both will require substantially more in the way of analytical skills and feasibility studies (or at least they will need to look into a much clearer crystal ball).

Types of Shopping Centers

The neighborhood center. Provides for the sale of convenience goods such as food, drugs, sundries and personal services. Designed to meet the daily needs of a residential area. Usually the anchor tenant is a food market but could it be a drug or hardware store. Most smaller strip malls have no anchor tenant, each relying on the other tenants to draw patrons. Commonly, sizes range from 20,000 to 50,000 sq. ft. of gross leasable area (GLA), with 5 to 10 tenants. The site could be as small as one acre but increases proportionally with increases in GLA. Minimum required trade area population: 2,500 people within a 5-minute travel time.

The community center. These centers are built around a junior department store, which could be a furniture, discount or drug superstore. It will usually have a larger grocery store as the anchor tenant. It typically does not have a larger department store. These centers offer a larger variety of goods and services than do the neighborhood centers. Typical GLA ranges from 100,000 to 250,000 sq. ft. with a site size of 5 to 15 acres. Trade area population requirement: 40,000 upwards.

The regional and super regional centers. In size, they usually range upward from 250,000 sq. ft. GLA upward. When over 750,000 sq. ft. they are considered as *super regional*. Most of these centers or malls contain two or three major department stores, numerous mid-size to smaller stores, food courts, specialty stores, service outlets, etc. Their drawing power extends up to 15 miles, modified by such factors as competition, highways, ease of access, etc. Site size would be 30 acres upwards so that a 4-to-1 parking ratio (4 sq. ft. of parking for every 1 sq. ft. of GLA) can be provided. Trade area population requirement: a minimum of 150,000 people.

In addition to the above classifications there are the fashion malls, glamour malls, discount centers, hyper centers, vertical malls, destination stores with a cluster of smaller stores around them, box stores, etc.

The Shopping Center as an Investment

Historically, the shopping center has been among the best and safest of all investment properties. The stabilizing force has been the anchor tenant, the larger department or food store. Accounting and tenant problems have been somewhat reduced by the formation of tenant associations and by the use of net and triple net leases.

Traditionally, vacancy rates in the better centers have been relatively low, showing a better return on the investment than office buildings or apartments. With established retailers there is goodwill of location that could be lost if they change locations. Although gouging the tenants with high rents is not a viable option, the landlord has more negotiating options.

Considerations

- Location as relative to the trading area is paramount. It must be within easy walking or driving distance from its intended customer base.
- The site must be of sufficient size to afford on-site parking to all patrons and staff.
- The site must be clearly visible. Ease of entry and safety of egress are important considerations.
- There must be proper inter-tenant balance. One of the pluses for these centers is cumulative attraction.
- There must be adequate management with controls so that the tenants work together, not at odds with each other.

- Excessive competition is a governing factor, internal from inside the center itself and external from other neighborhood developments.

OFFICE BUILDINGS

Reliable estimates indicate that since 1960 there has been approximately 15 billion square feet of office space added to the previous inventory in the United States. The reported present total inventory approaches the 17 billion square foot mark, with the major concentration in the central cores of the major cities. This is approximately 50 square feet for every person in the nation. At this same time, every town and every city has office buildings of some type, most of which are relatively safe investments. Like the shopping center, as size increases, required equity and management responsibility increase proportionally.

Types

Office buildings could be classed as *single tenant*, *multi-tenant* and *mixed use*. Mixed use would include offices combined with apartments, retail stores, recreational and cultural facilities, a hotel, parking garage, etc. There is no smallest or largest size. A freestanding building could have as little as 500 or as much as one million square feet of floor space. There are five general classifications of office buildings:

1. **Trophy buildings**. These are normally single tenant properties, usually owner occupied. They are distinguished by unique design and layout, a high quality location, above-average quality of materials, and are usually built at an above-average construction cost. Often, they contain a high element of built-in functional obsolescence. This type of building is most commonly found as a head office for a major corporation , and at times, could be a bank, a government building, a concert hall or a courthouse. From a revenue perspective, the potential income will seldom offset the higher cost of construction and operation sufficiently enough to provide other than a bare minimum return on the investment.

2. **Class A**. This is the top-grade, investor-owned and managed building. It is normally well located, usually downtown or in a peripheral corridor, is of quality construction, well-appointed, properly maintained, occupied with good caliber tenants and offers a variety of nearby amenities for its tenants and their employees. It is occupied by a mixture of offices and professional services.

3. **Class B**. Often an older building or, if newer, one that is out of the main traffic flow. More of a commercial building, constructed at a lower cost for maximum space utilization with only the minimum of frills. It normally has an ordinary design with average to good quality maintenance and tenants. In the majority of cities, this is the most common type of low to medium-rise office structure.

4. **Class C**. This is a minimum quality, usually older or mid-life, no-frills structure. It normally has inadequate heating, often no air conditioning, only adequate maintenance and low prestige. A building of this type can be located anywhere, usually does not have much rentable square feet and seldom is higher than three stories. These structures are often ideal candidates for renovation and modernization. As investments go, they are usually the best of the group, but are seldom status symbols.

5. **Class D**. These are buildings that should be knocked down and the site redeveloped. Although it is possible to renovate some of these structures, seldom is the result worth the cost.

Functions of Office Buildings

Before investing in an office building, whether to flip, own or rehabilitate, it is wise for the investor to determine how and where it fits into the scheme of things. Office buildings can serve a variety of purposes. It can be:

- **An activity center**. Simply a place to work and to conduct business.
- **A generator**. People come from all over to do business with the tenants of the building, but while there, patronize others. The best examples of this are the mixed-use office and retail store buildings.

- **A social center**. Office buildings that contain restaurants or nightclubs and are suitable for civic functions, etc.

The Office Building as an Investment

Traditionally office buildings have been among the more stable of real estate investments. Yet office buildings always seem to be overbuilt, have high periodical vacancy rates and are the first to suffer when there is a downturn in the economy. At the same time, they are good equity builders, provide a competitive return on an investment and usually offer a measurable value appreciation.

Considerations

When investing in office buildings, one cannot throw caution to the wind. Take into account:

- **The location of the building**. Is the location appropriate for the tenants and the type of business they are in? Medical doctors want to be near hospitals. Lawyers like to be downtown. Advertising agencies can be anywhere.
- **Neighborhood safety**. This is a growing consideration.
- **The class of building**. Can it attract the quality of tenants that you want without major renovations? If not, is rehabbing a worthwhile project? If you cannot increase the net income sufficiently to pay for the cost of renovations within a reasonable length of time, the answer is no.
- **The configuration of the building**. Can present offices be expanded without a major restructuring of the building? Is the building adaptable for other tenants or other uses?
- **The age and construction of the building**. This often dictates adaptability and obsolescence.
- **The structure of the building**. If a building is totally out of character with its surroundings, size, shape, height, design, history of tenants, etc., it will be hard to fill up and still harder to sell.
- **Condition**. Look at the structure, cosmetic aspects, services, equipment and amenities.

- **Marketability**. Is there a market for this building, as is, after renovations, as if vacant? How long will it take to sell and what concessions must you make?

- **The increasing trend away from offices**. Today many businesses can be run from one's home or automobile. All it takes is a cell phone and a laptop computer. This is a trend well worth watching.

INDUSTRIAL PROPERTIES

If you buy wisely, rent selectively and manage judiciously, the industrial property can be a very good investment, often with no more risk and less management than comparable real estate investments.

The classification *industrial property* is probably the broadest of all segments of investment real estate. This would include manufacturing buildings, warehouses of all sizes and descriptions, loft buildings, storage buildings, contractor's shops, etc.

Types

There are two specific categories of industrial buildings.

- **General purpose**. These are usually warehouse type structures that can be readily adapted for alternative uses or for different occupancies.

- **Special and single purpose**. These are buildings that usually have what would be best considered as odd sizes, shapes and configurations. Seldom can they be used for anything other than the originally intended use. Otherwise, they may require high-cost renovations or restructuring.

Frequently, a user will develop this type of property and, as it feels its capital is better invested in the business, will sell the property and lease it back.

Industrial Properties as Investments

From an investment perspective there is really not that much difference between industrial properties and the other more common types of commercial real estate, just a few special concerns and warnings. In the end, it always comes down to investing a certain amount of money and anticipating a return on that investment.

Often beneficial financing can be arranged for industrial properties, particularly if they are occupied by manufacturers or processors. No city or town wants to run the risk of losing what is there—an employer, a traffic builder for other businesses, a supporter of the community and a larger taxpayer. Additionally, all states, industrial development groups and many utility companies spend millions of dollars to attract new industry to their community. Investors in industrial properties should thoroughly investigate the availability of government grants, subsidized loans and plain ol' handouts.

Considerations

- Intended use of property—processing, production or storage
- Land and building space requirements
- Land and building conformity to requirements
- Secondary functions—offices, administration, design
- Layout and construction of building, ceiling heights
- Requirement for lifts, elevators, conveyors, etc.
- Storage of raw materials
- Storage of goods—in process of production and finished
- Staff amenities—wash and lunchrooms, etc.
- Repair and tool shops
- Utilities, HVAC, electrical, water and sewer, etc.
- Loading and unloading docks and facilities
- Parking for employees and visitors
- Second buildings, cold storage, welding shops, etc.

Concerns for the Investor

- **Location of the property**. With manufacturing and warehouse buildings, accessibility is a major concern. The avenues and streets that provide for site entry and exit must be wide enough and with sufficient visibility to accommodate large trucks. They must be close enough to the traffic arteries so that these trucks are not traveling through the main retail or residential sections of the city.

- **Size and topography of site**. The site must be large enough for adequate outdoor storage, and again for large trucks to enter the site, travel around it, be able to back up to warehouse doors, load or unload and exit the site safely.

- **Functional obsolescence**. This is a major concern in industrial buildings, particularly special or single purpose ones. Do we really need the floor carrying capacity, electrical service, high intensity lighting, ceiling heights, etc.—for any purpose other than that of the original occupant's?

- **Convertibility, particularly of single-use properties.** There are many empty factory buildings that have little value as they cannot be converted economically. The risk of having a totally vacant building is substantially reduced if it can be partitioned and the various areas rented to different tenants.

- **Land-to-building size ratios.** Usually industrial sites are grossly underdeveloped. If vacated, can the site be redeveloped for a better highest and best use?

- **The trend in warehousing.** There is a new movement to vertical warehousing, that is, box buildings with 30 to 50 feet ceiling clearances. Goods are stacked in layers or on shelves, picked up by and placed on conveyors, and often boxed by computer operated robotic machines.

Warning Signs

With many properties, the red flags are flying. One should watch for:

- Single purpose buildings and properties that are suitable only for the user, which is most often the present or last tenant. It is common to see larger abandoned industrial and warehouse properties for which the cost of conversion to another use is prohibitive or where there is no market, no matter what you do.

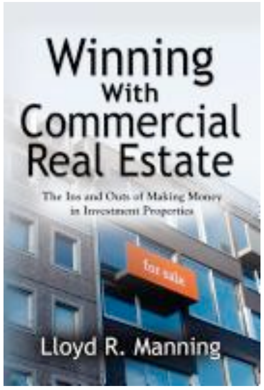
- Industrial properties in smaller communities or a long way out of town or in a single industry town, where the health of the community depends on that sole industry.
- Industrial properties built more for political reasons than for good economic sense, such as attracting an industry into a particular community when it should have been built elsewhere. Often with these industries, when the concessions run out, so does the owner or tenant.
- Properties in industrial parks that are devoted almost exclusively to a single industry.

> ***Case in point:*** Located southeast of Edmonton, Alberta, Nisku Industrial Park is devoted almost exclusively to the oil industry. Although it has rapidly recovered from a few years back, for a time, it was almost totally shut down during the recession in the oil industry. A high percentage of the properties in this park, including some very large manufacturing buildings, were under foreclosure of one form or another.

OTHER DEVELOPED PROPERTY OPTIONS

- **Mobile home parks**. These can be rental only parks, condominium parks or combinations. These are now being developed as permanent housing, seasonal parks and recreational vehicle parks. Usually they are good investments, but require a very high level of maintenance and management. Although the quality of mobile homes, now referred to as *manufactured homes*, is greatly improving, they still have a poor reputation. The permanent accommodation parks still cater to those who are looking for housing at a lower cost than conventional residential properties. To be successful one must develop a strict code of bylaws regarding the type of homes allowed into the park, what level of care their owners must maintain and there are strict rules about getting along with the neighbors. Then, the rules must be enforced to the letter. It is far too easy for these properties to become low cost, low maintenance, run down and attract only disreputable occupants.

- **Motels**. These are always high on the list of desirable properties for those who wish to semi-retire, have an easy job and be able to live in the building. Do not kid yourself. Owning and operating a motel is a 24 hour, 7 day a week occupation. Unless you are fortunate enough to own a large motel, there is seldom enough revenue to hire additional help. Therefore, you are the receptionist, security, accountant, chambermaid, repairman, and all else. If the motel is well located and well managed, it can pay well, but motels are seldom that much better than other investments once a fair wage for the owner/manager is deducted. When considering a motel, always try to obtain one of the major franchises. If for any reason a franchiser will not take you on, do not buy the motel; only the poorest and most careless of patrons will stay there.



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