

WEALTH OPPORTUNITIES

IN

COMMERCIAL REAL ESTATE

MANAGEMENT, FINANCING, AND
MARKETING OF INVESTMENT PROPERTIES



GARY GRABEL


30807719

Wealth ties in Commercial Real Estate

MANAGEMENT, FINANCING, AND MARKETING
OF INVESTMENT PROPERTIES

Gary Grabel



John Wiley & Sons, Inc.

Copyright © 2012 by Gary Grabel. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

Argus spreadsheets courtesy of ARGUS software. © 2011 ARGUS Software, Inc. All Rights Reserved.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at www.wiley.com/go/permissions.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our website at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Grabel, Gary.

Wealth opportunities in commercial real estate : management, financing and marketing of investment properties / Gary Grabel.

p. cm.

Includes index.

ISBN 978-1-118-11574-9 (cloth); ISBN 978-1-118-19722-6 (ebk);

ISBN 978-1-118-19723-3 (ebk); ISBN 978-1-118-19724-0 (ebk)

1. Commercial real estate. 2. Real estate investment. I. Title.

HD1393.55.G73 2011

332.63'24-dc23

2011028238

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

*This book is dedicated to
Mark Hamermesh and Aric Browne:
Without their efforts and drive,
this book would not have been possible.*

*By taking on their shoulders
many of the day-to-day problems and concerns
associated with running a real estate company,
which owns and operates
several million square feet of shopping centers,
medical office buildings, and apartment units,
they made it possible for the author
to focus on writing these pages.*

*This book is also dedicated to my wife, Rosanna,
who has put up with my quirks
and idiosyncrasies for over 30 years,
especially when I wanted to work
on this book rather than spend time
in some more enjoyable pastime.*

List of Abbreviations

Act	The Securities Act of 1933
Cap X	Capital Expenditures
CFBT	Cash Flow before Taxes
Code	Internal Revenue Code
DCR	Debt Coverage Ratio
FMV	Fair Market Value
IRR	Internal Rate of Return
LLC	Limited Liability Company
LP	Limited Partnership
LTV	Loan to Value
NOI	Net Operating Income
NPV	Net Present Value
NRSF	Net Rentable Square Foot
PSA	Purchase and Sale Agreement
PSF	Per Square Foot
PV	Present Value
ROA	Return on Assets
ROE	Return on Equity
SEC	Securities and Exchange Commission
1031	Section 1031 of the Internal Revenue Code

Introduction

This book is the result of many people asking me “How can I buy income-producing property? How can I get into the game?” The underlying purpose in this book is to set forth a practical step-by-step process on how to acquire commercial real estate and through a real estate vehicle build significant wealth over time. The discussion runs from sourcing a real estate transaction to analyzing the deal to acquiring the sticks and stones to managing real property to improving its value and finally to taking steps to preserve the value created and hopefully passing a good part of it on to your children and your children’s children.

Unfortunately, there is a wealth of books on real estate that in essence say, “You can’t lose. Go out and buy real estate!” You can lose in real estate just as in any other business. I usually buy from someone who has “lost”; that is, the value of the property and their equity therein has decreased from the date of their purchase. It is therefore essential to understand the fundamentals of the real estate game, including how to evaluate a real estate transaction and how to create value before you take the plunge and start to buy.

The text is geared to the novice who wants to understand commercial real estate as well as the seasoned professional who desires to enhance his knowledge. One of the key teaching tools revolves around setting forth a hypothetical that starts with the basics and then continually builds on the fact pattern to demonstrate real estate principles and theory and enhance the project analysis.

Although the concepts herein can be applied to all types of real estate, the focus is directed toward a project size of 30,000 to 150,000 square feet as is typically found in a neighborhood shopping center rather than a huge office building or a complex of over 500,000 square feet that might be found in a downtown high rise tower or a regional shopping mall.

Many individuals in the real estate field specialize in one area and therefore have a difficult time understanding and learning practical knowledge about other areas of real estate ownership. This text attempts, to some extent, to fill this gap. By covering a broad range of real estate topics from basic terminology and analysis to leasing, financing, marketing, management, structuring a partnership, real estate tax consequences, buying and selling real property, and the steps to take to preserve wealth, hopefully the reader can focus on the areas of his or her deficiencies.

Although I am an attorney by background, *Wealth Opportunities in Commercial Real Estate* is not intended as a legal treatise; rather, its focus is directed to the practical, day-to-day business aspects of acquiring, owning, and managing commercial real estate. I strongly recommend consulting with an attorney, accountant, and other professionals when entering into a lease, a purchase and sale agreement, or when any technical issues arise.

A thank you to ARGUS Software, who graciously supplied their proprietary software for use in connection with the Cash Flow spreadsheets for this book. These, among other Appendices, can be found at the companion website, www.wiley.com/go/wealthopportunities. This supplementary material will surely provide you with a wealth of examples to review as you read through the book.

Contents

List of Abbreviations	xiii
Introduction	xv
Chapter 1 An Overview of the Problem, a Solution, and a Game Plan	1
The Problem	1
The Solution	2
Four Key Elements in the Solution	3
Concerns about the Solution	8
Acquiring the Skill Set to End the Cycle	9
A Game Plan to Achieve the Solution	9
This Book Is about Center B Properties	18
Chapter 2 The Basics	21
Gross Income: The Starting Point	21
Vacancy and Collection Loss: Gross Income Reducers	21
Operating Expenses and Net Operating Income	23
Fair Market Value and Capitalization Rate: What's It Worth?	24
Gross Rent Multiplier	25
Value per Square Foot versus Reproduction Cost per Square Foot	26
Inverse Relationship between Cap Rate and FMV	29
Initial Determination of Value	29
Leveraged Return and Return on Equity	30
Cash Flow before Taxes (CFBT)	32
Reserves/Impound Accounts	32
Taxes and Insurance Impounds	32

	Cap X, TIs, and Leasing Commissions	33
	Devil in the Details: Over Simplified Analysis	38
Chapter 3	Detailed Financial Analysis	41
	Gross Income	41
	Vacancy and Collection Loss	43
	Operating Expenses	43
	Four Basic Types of Leases	46
	Nonrecoverable Expenses	55
	Time-Frame Assumptions	56
	Static versus Active Analysis	57
	Compounding	58
	Rent Roll	59
	Argus Ten-Year Discounted Cash Flow Model	60
	Analysis Reflecting 100 Percent Occupancy	65
	Reversion	66
	Disposition Costs	66
	The Time Value of Money: Present Value and Discounted Cash Flow	67
	Net Present Value (NPV)	68
	Internal Rate of Return (IRR)	68
	Conclusions from Argus Analysis and the Hypothetical Facts	69
	Analysis Reflecting a Large Vacancy after Purchase	70
	Analysis Reflecting a Large Vacancy with a Tenant in Tow	72
Chapter 4	Lease Analysis	75
	The Importance of Basic Lease Provisions	75
	Twelve Key Economic Ingredients in a Lease	77
	Frequently Negotiated Lease Provisions	96
Chapter 5	Real Estate Financing	119
	Sixty to Eighty Percent of the Game	119
	Types of Financing	120
	What Is the Right Answer to Debt Structuring?	122
	Seven Key Factors to Consider in a Real Estate Loan	124
	Loan Underwriting	131
	Cash-on-Cash Return	137
	The Mortgage Loan Application	138

	The Pitfalls of Mortgage Lending	138
	Negotiable Points of a Loan	153
Chapter 6	Real Estate Taxation	157
	Income Taxation	157
	Real Property Taxation	163
	Taxation in the Event of a Refinance	164
	Taxation in the Event of a Sale	165
	Installment Sale	166
	Section 1031 Exchange	168
Chapter 7	Acquisitions and Dispositions	179
	Focus on Specific Property Types in Specific Geographic Locations	179
	Establish Buying Criteria	181
	Acquisition Philosophy	181
	Governmental Impact	182
	Initial Screening	183
	The Purchase and Sale Agreement	187
	Building a Team	199
	Due Diligence	199
	Dispositions	206
Chapter 8	Case Studies	219
	Problem Number 1	219
	Problem Number 2	230
	Problem Number 3	242
	Problem Number 4	244
	Problem Number 5	248
	Problem Number 6	255
	Problem Number 7	258
Chapter 9	Development or Rehabilitation (Build to a 12 Percent Yield)	269
	The 10 Phases of a Construction or Rehab Project	269
	Assessing a Construction Project	270
	Developer as Conductor	272
	Does the Project Hit Your Minimum Yield?	274
	Argus Developer	279

Feasibility or Market Study	283
The Composition of a Feasibility Study	284
Residual Land Value	285
Preleasing	286
Equity and Financing	287
Mechanics' Liens	287
Liability under the Construction Loan	288
Design and Construction Drawings	289
Governmental Approvals	290
Covenants, Conditions, and Restrictions (CC&Rs)	291
Ground Lease Restrictions	292
Construction of Improvements in a Ground-Up Development	292
Inspections	295
Insurance	296
Decisions, Decisions, Decisions	296
Communication, Communication, Communication	298
Graphic Time Line	299
Project Operating Costs	302
Lender's Disbursement Form	303
Change Orders	303
Rehabilitation Project	303
Construction of Improvements in a Rehab Project: Decisions, Decisions, Decisions	311
Rehab Project: Communication, Communication, Communication	311
Summary	311
Chapter 10 Marketing, Leasing, and Management	313
Definition of Marketing, Leasing, and Management	313
Marketing	314
Leasing	319
Strategy	319
Management	345
Management as a Business	353
Conclusion	354
Chapter 11 Partnership Structuring and Deal Restructuring	355
Partnership Structuring	355
Securities Issues	357

Fifteen Key Structuring Issues	361
Debt Restructuring	371
Borrower's Proposed Terms	383
Lender's Counterproposal	384
Chapter 12 Keeping the Money	389
Planning	389
Fractional Interests	396
Estate Planning Checklist	400
 Acknowledgments	 403
About the Website	405
About the Author	407
Index	409

CHAPTER 1

An Overview of the Problem, a Solution, and a Game Plan

The Problem

If you are like 99 percent of the people on this planet, you have a problem: Namely, you must work to make money to eat and live.

It is a vicious cycle. You get up at 7:00 A.M., get out the door by 8:00 A.M., arrive at work at 9:00 A.M., push paper around all day, and leave at 5:00 or 6:00 P.M. You follow the same routine day after day. Your net pay is, say, \$70,000 per year, you give 20 to 25 percent away to Uncle Sam, and your annual living expenses eat up the remaining money. The net result at the end of the year is no savings—zero, a goose egg, *nada*.

The next year you get a big promotion and an accompanying raise of 5 to 10 percent (if you are lucky). You have been waiting all year for this big raise. Your family has grown from husband and wife to husband, wife, and baby, and now you are expecting your second child. All year you have been putting off buying the new, latest and greatest big-screen television system and the much-needed trip to Hawaii, not to mention replacing that overused, tired Acura with a new Mercedes. What do you do to satisfy these pent-up demands? How do you satisfy these desires that have driven you for the past couple of years? The answer is that you move out of that cramped 1,500- to 2,000-square-foot apartment into a “decent” 3,000- to 4,000-square-foot home with a real backyard, you buy on credit the big screen “deal,” you take the family on the long-delayed vacation

to Hawaii, you lease a new car, and so on. The point is that you find a way to spend your increased wages and, with inflation, you are back in the same breakeven position you were in when you started a year ago, or even worse, since you have significantly increased your debt position.

We have identified The Problem, the cycle: You are working to meet the necessities of life including paying your silent partners (the state and federal governments), and you are consuming any remaining cash to satisfy pent-up demands for goods and services.

The Solution

The question becomes, how do you break this cycle? What is The Solution?

There is no single right answer to this question. There are several solutions to The Problem. The best solution I have found lies within the realm of real estate. You buy a *value-added property*, by which I mean a property that through your focused efforts can be improved and enhanced so it is worth significantly more after your efforts than when you acquired the asset. Your efforts usually revolve around increasing occupancy, but it can be a myriad of other tasks such as improving the overall appeal of the property through structural or cosmetic changes or changing the tenants by bringing in more viable businesses or more synergistic users, and so forth. Let's call your first acquisition "Property Number 1." You then:

- Acquire Property Number 1.
- Lease up or otherwise improve Property Number 1.
- Refinance Property Number 1, pulling out monies in excess of the existing debt at least equal to the original equity invested.
- Invest the refinance proceeds into another property (Property Number 2).
- Continue to manage Property Number 1, reaping the benefit of the positive cash flow and earning a management fee.
- Lease up or otherwise improve Property Number 2.
- Refinance Property Number 2, pulling out monies in excess of the existing debt at least equal to the original equity invested.

- Invest the refinance proceeds into another property (Property Number 3).
- Continue to manage Properties Number 1 and Number 2, reaping the benefit of their positive cash flow and earning a management fee.
- Lease up or otherwise improve Property Number 3, and so forth.

Four Key Elements in the Solution

Why does this Solution break the cycle? Because of four key elements.

Key Element Number 1

First, you are no longer limited in your earning potential by your salary or by your professional endeavors; rather, you have become an investor. You have converted active income into passive income. When you sleep at night, when you go on a vacation, you continue to make money. Your assets appreciate (hopefully) in value over time and in the normal course of events each month you build equity by paying down the principal on your mortgage. A mortgage usually contains an amortization feature; therefore a portion of each payment reduces the outstanding loan balance and consequently increases your equity, everything else being unchanged.

Usually the individual caught in the cycle is employed, earning a good living, but his livelihood is based upon his own individual capacity to do a job and get paid for that work. The basis of The Solution is a move to a business model that has the capacity to create wealth, not only from individual effort, but also based upon market forces. If you correctly analyze the market and correctly perceive that *capitalization rates* or *cap rates* (the rate of return an investor requires to induce him to purchase a property for all cash without regard to financing) will likely fall from 10 percent to 7 percent, then, even if no other change occurs in the real property investment, your property value will increase significantly. Market forces have resulted in a value shift. Similarly, if you purchase a property in a growth community and the resulting population growth fuels an increased demand for goods and services, that results in an upward push in rents, which translates into a higher net operating

income, and therefore an increased property value. Again, market forces have driven value upward.

It is important to understand the difference between *active income* and *passive income*.

Active income is income earned through services rendered or goods sold. What is meant by “services rendered”? The concept of services for hire includes the broad area that comprises everything from practicing medicine to providing janitorial services. “Goods sold” refers to any product sold, from real estate to pencils.

The more difficult and more esoteric question is: What is *passive income*? Simply put, what I mean by passive income is income earned *not* by rendering services or selling goods. This does not mean that you do not have to work to make passive income, but rather that your work is of a different nature. Owning stock in a company, or for that matter owning the company itself, is an example of creating passive income. The employees of the company perform the functions that generate profits and dividends for its shareholders. The point is that the owner of the stock did not actually have to perform “labor” to receive the dividends paid. Similarly, the owner of real estate earns profits from rents, yet he does not actually provide services to the public or sell goods to the public. The delivery of services or the sale of goods is the function of his underlying tenants.

I want to emphasize once more that earning passive income does not mean that you do not have to work. The stockowner must spend time researching or hiring someone to research profitable stock selections and the monitoring thereof. Also, the real estate entrepreneur must operate his properties or employ a property manager. It can be demanding to invest in the stock market or to own and manage real estate. The individual who establishes a profitable stock portfolio did his research or had research done on his behalf. He verified that the company whose stock was purchased has a good management team, reasonable liquidity to survive tough times, growing sales, and net profits. He might also have an insight into the industry trends relating to the applicable field. Similarly, owning and managing real estate is a business. It requires insight to know when to buy and when to sell, as well as where to buy and where not to buy. Once a property is acquired, someone must invoice the tenants, collect the rents, coordinate vendors, and deliver services to tenants to ensure efficient operation of the asset. Someone must lease-up vacant space and make strategic decisions ranging from tenant mix to the overall look of the property

to whether or not to expand the project by building-out additional leasable square footage to whether to refinance or sell. If a decision is made to refinance or sell, an individual must decide under what terms to borrow or under what terms to sell.

Notwithstanding the above, being a stock investor or a real estate owner is, in general, more akin to managing an investment as opposed to running an operating business that might require hundreds of employees. Yes, to be successful you need insight into what to buy, but you can to a large extent outsource the selection of the asset, as well as its care and feeding thereafter. That said, a good full-time investor will, at a minimum, manage his managers, and a superior full-time investor will take an active role in his business even though his business is not, in general, a labor-intensive one.

Rule Number 1

Convert active income into passive income.

Key Element Number 2

The second crucial step in breaking the cycle is to create a cash-flow model that generates consistent monthly dollars that can be built upon so that within a certain time frame the monthly cash flow equals \$2X.

In other words, relating this step back to The Solution, if, for example, Property Number 1 generates \$10,000 per month in revenue, then acquiring and leasing-up Property Number 2, which generates \$10,000 per month in revenue, results in a cumulative cash flow of \$20,000 per month. Acquiring and working Property Number 3 results in another \$10,000 per month in net cash flow for a cumulative \$30,000 per month.

Obviously, stating the objective is quite a lot easier than locating a property and executing a game plan that will generate a significant positive cash flow. However, the important point is that, yes, it is important to build value, but it is also important to build monthly cash flow.

Rule Number 2

Create a monthly cash flow model and build upon that model.