

The Basics of Commercial Real Estate

A Layman's Guide to Getting Started

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Agenda

- The Commercial Real Estate Market
 - Property Acquisition
 - Management & Disposition
- or -
- Why to buy
 - How to buy
 - How to hold and sell

Why Commercial Real Estate?

Real (estate) Facts

- 7 out of every 10 millionaires in this country made their fortunes in real estate.



- You are three times more likely to become wealthy through real estate than any other form of investment.

Forbes

CRE Investment Reasons

- Portfolio Diversification
- Principal Preservation
- Retirement Income
- Tax Advantages
- Appreciable Asset
- Competitive Yields

“For many it’s not just an investment strategy, it’s a way of life.”

The Big Four: “ACED”

- Appreciation
- Cash flow
- Equity build-up
- Depreciation



Develop an Investment Plan

- Goals & Objectives
- Market & product knowledge
- Assemble a qualified team
- Funds & financing
- Timeframe

***“A good plan, violently executed now,
is better than a perfect plan next week.”***



General G.S. Patton

CRE Considerations

- Risk
- Liquidity
- Leverage
- Location
- Management
- Holding Period
- Value Change
- Tax Impact

Commercial Property Types



Multi-family



Retail



Office



Industrial

Other Commercial Investments

- NNN (triple-net, leased investment)
- TIC (Tenants in Common)
- Land (Land bank)

Related CRE Securities Investments

- REIT (Real Estate Investment Trusts)
- CMBS (Commercial Mortgage Backed Securities)

SFR vs. CRE

Residential Property

- Buyer protection laws
- Easier to find & finance
- Lower down payment
- Lower rate of return
- Local market

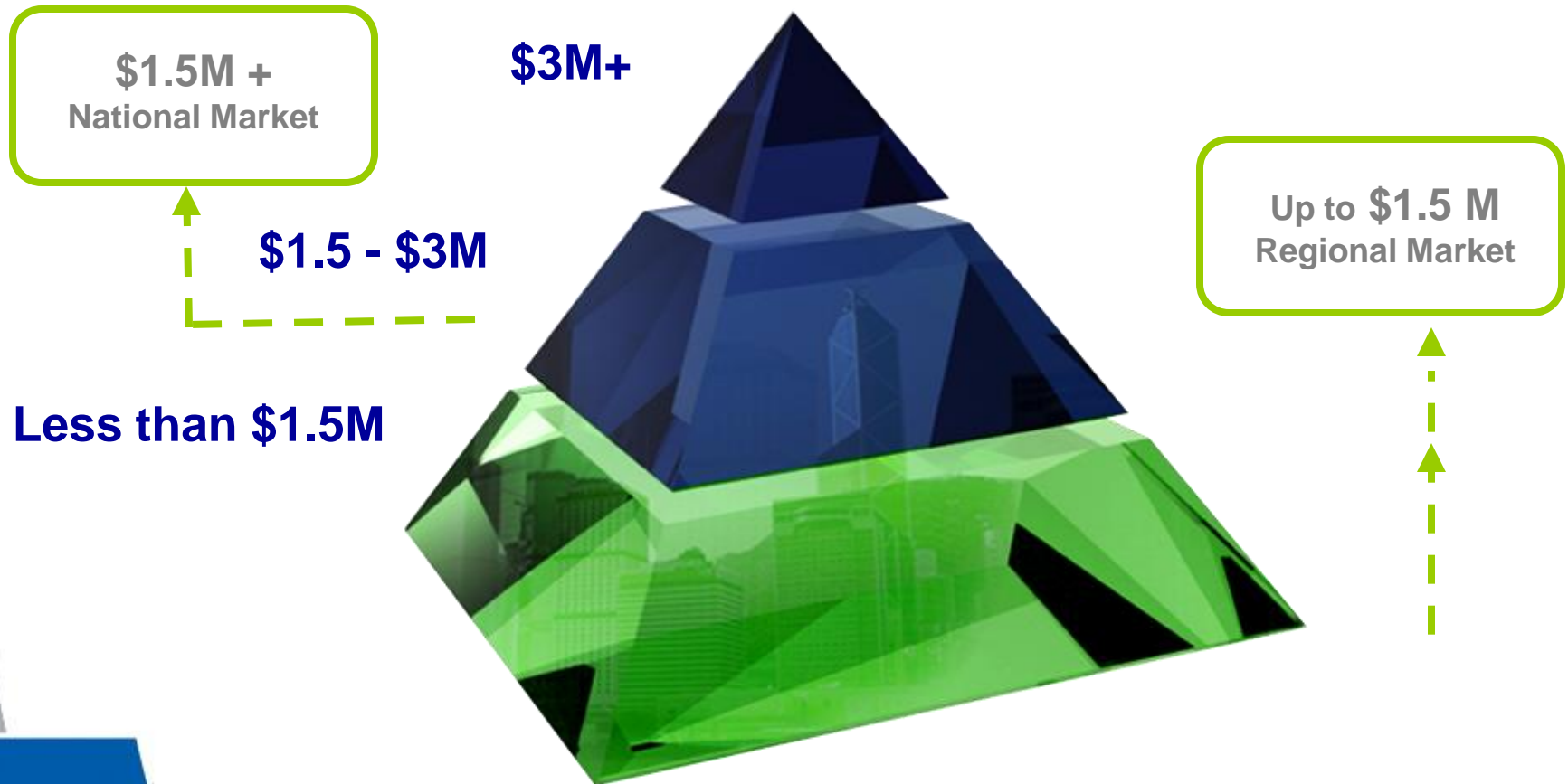
Commercial Property

- Caveat Emptor
- Difficult to find & finance
- Higher down payment
- Higher rate of return
- National market



VS

CRE: A National Market



Property Acquisition

Buying a Building

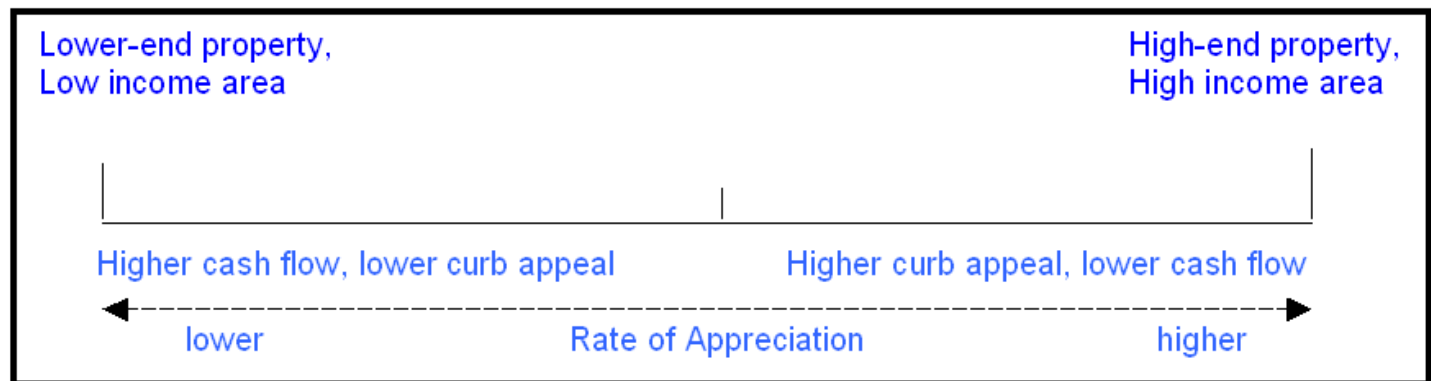
- Profile the ideal property
- Have funds & financing available
- Use a qualified broker
- Know the market
- Run the numbers
- Do your Due Diligence

Tapping the CRE Market

- No Commercial MLS
- Your Commercial Broker
 - Property Access
 - Understanding “broker cooperation”
- Commercial Websites
 - www.loopnet.com
 - www.propertyline.com
 - www.ccim.net
- Commercial Brokerage sites

PooP vs. Slums

Condition vs. cash flow?



Financial Analysis

Cash Flow After Tax

Potential Rental Income (PRI)
+ Other income (affected by vacancy)
- Vacancy & credit losses

Effective rental income
+ Other income (not affected by vacancy)

Gross Operating Income
- Operating Expenses

Net Operating Income (NOI)
- Annual Debt Service (ADS)

Cash Flow Before Tax (CFBT)
- Tax Liability

Cash Flow After Tax (CFAT)
=====

Key Metrics

- Capitalization Rate: $\text{Cap Rate} = \text{NOI}/\text{Price}$
- Gross Rent Multiplier: $\text{GRM} = \text{Price}/\text{PRI}$
- Price per unit = $\text{Price}/\# \text{ of units}$
- Cash-on-cash return = $\text{CFAT}/\text{Amount invested}$
- Internal Rate of Return or Yield

N	\$
0	<Initial Investment>
1	Annual CFAT
2	Annual CFAT
3	Annual CFAT
4	Annual CFAT + SPAT

$i = \text{IRR}$

Market Snapshot

Address	City	Units	List Price	GRM	Cap Rate	DOM	GSI	NOI	Sq. Ft.
262 HIGDON	MV	10	\$1,350,000	14.6	4.5	35	\$97,430	\$60,333	6,000
2002 W MIDDLEFIELD RD	MV	10	\$1,939,999	14.3	5.1	2	\$136,080	\$98,016	9,934
4734 HAMILTON AV	SJ	10	\$1,850,000	13.8	5.8	160	\$134,340	\$107,580	8,252
39 ATLAS AV	SJ	10	\$1,450,000	16.5	4.3	47	\$92,400	\$62,015	5,202
1185 BIRD AV	SJ	10	\$1,468,000	14.2	5.7	70	\$103,452	\$83,718	5,831
2131 MARLBORO CT	SJ	11	\$1,665,000	15.4	4.4	154	\$111,650	\$72,614	5,757
150 BLOSSOM HILL RD	LG	12	\$2,199,900	16.6	4.3	138	\$132,564	\$93,914	6,968
528 S 10TH ST	SJ	12	\$1,560,000	12.1	6.3	40	\$135,720	\$97,559	9,496
260 N 3RD ST	SJ	12	\$1,550,000	13.9	0.0	40	\$117,480	\$10,991	5,680
804 S ALMADEN	SJ	12	\$1,450,000	14.7	5.1	19	\$103,800	\$73,900	5,680
649 BLYTHE CT	SU	12	\$2,050,000	14.5	4.8	25	\$148,800	\$97,500	8,792
358 N 7TH ST	SJ	13	\$1,560,000	12.4	0.0	40	\$132,150	(\$1,192)	6,536
357 S 4TH ST	SJ	13	\$2,155,000	13.4	6.0	181	\$160,450	\$129,877	9,545
655 RESEDA DR	SU	14	\$2,150,000	15.1	4.7	19	\$150,128	\$100,320	7,494
560 S 10TH ST	SJ	15	\$2,125,000	12.2	5.3	6	\$177,540	\$112,604	9,808
270 E OKEEFE ST	EP	16	\$2,850,000	14.6	5.8	8	\$195,840	\$165,565	20,774
2080 MARLBORO CT	SJ	16	\$2,100,000	12.9	5.6	7	\$167,760	\$117,158	9,316
102 S 14TH ST	SJ	16	\$1,500,000	12.4		4	\$127,428	\$86,295	4,042
255 N 3RD ST	SJ	16	\$1,895,000	12.5	5.0	210	\$158,950	\$95,602	6,525

Note: This information is believed to be accurate but is not guaranteed.

Sample Property



- List Price: \$2,100,000
- Unit Mix: (12)1x1, (4)2x1

<u>Income:</u>	
Gross Rent Income:	\$158,420
Laundry:	\$4,800
TOTAL INCOME:	\$163,220
<u>Expenses</u>	
Real Estate Taxes:	\$24,212
Insurance	\$5,268
P.G. & E.	\$5,036
Water	\$4,051
Garbage	\$2,202
Pool	\$1,200
License+permit	\$1,280
Maintenance	\$4,800
TOTAL EXPENSES:	\$48,049
EXPENSES/UNIT:	\$3,004
% of EGI:	29.40%
Cash Flow Before Debt: \$115,171.00	

“Does it pencil?”



Property Investment Analysis

Property Information			Investment Summary				
Property Name	Alden Way Apartments		Price:			\$2,950,000	
Address	3517 Alden Way		GRM:			10.9	
City, State	San Jose, CA		Cap Rate:			6.2%	
# of units	20		Price per foot			\$182	
Building Size (approx)	16,200		Price per unit			\$147,500	
Lot Size (approx)	22,900		Est YR1 Cash-on-Cash Return			4.98%	
Age	43		Debt Coverage Ratio			1.26	
Remarks: Income as of Dec 2003.			DCR Qualifying Rate			6.50%	
Initial Investment			Proposed Primary Financing				
Price		\$2,950,000	Primary Loan Amount			\$1,917,500	
Down Payment	35.0%	\$1,032,500	Interest Rate	5.500%		5.500%	
Borrowed Funds		\$1,917,500	Amortization Period	30		30	
Est Acquisition Costs	0.20%	\$25,075	Loan Term	5/30		5/30	
Initial Investment		\$1,057,575	Payments/Yr	12		12	
			Number of Payments	360		360	
			Monthly Debt Service			\$10,887	
			Annual Debt Service			\$130,648	
			Loan Points	1.0%		\$19,175	
Annualized Operating Data			Pro Forma Scheduled Income				
Scheduled Gross Income		\$271,520	<u>Unit Qty</u>	<u>Beds</u>	<u>Baths</u>	<u>Rent/Unit</u>	<u>Current Income</u>
Actual Vacancy Factor	4.5%	\$12,047	1	2	1	\$1,475	\$1,475
Effective Operating Income		\$259,473	2	2	1	\$1,295	\$2,590
Less: Expenses	28%	\$76,168	1	2	1	\$1,250	\$1,250
Net Operating Income		\$183,304	1	2	1	\$1,175	\$1,175
Less: Annual Debt Service		\$130,648	2	2	1	\$1,150	\$2,300
Cash Flow Before Taxes		\$52,656	1	2	1	\$1,095	\$1,095
Est. Annualized Expenses			1	2	1	\$1,055	\$1,055
Property Taxes (est)	1.20%	\$35,400	6	2	1	\$1,050	\$6,300
Insurance (est)		\$8,500	1	1	1	\$975	\$975
Maintenance		\$1,325	1	1	1	\$895	\$895
landscaping		\$1,800	1	2	1	\$850	\$850
Garbage		\$1,463	1	2	1	\$1,025	\$1,025
Gas & electric		\$3,496	1	2	1	\$1,325	\$1,325
Water & sewer		\$4,529					
Reserves		\$0	20				
Management (est)	6%	\$16,291	Total Units			Monthly Scheduled Rents	\$22,310
Misc: cleaning, paint, supplies		\$3,364				Annualized Rents	\$267,720
Total Expenses	28%	\$76,168				Other Income (laundry)	\$3,800
						Annual Gross Scheduled Income	\$271,520

Commercial Sales Protocol

1. Review listing, drive-by:
“Subject to inspection”
2. LOI first, then written contract
3. Various types of contracts
4. Legal review then acceptance
 - Clauses & addendums
5. Initiate financing & Due Diligence
6. Renegotiation

Protocol (continued)

7. Remove physical contingencies
8. Increase of deposit
9. Remove financing & appraisal contingencies
10. May or may not “**Go Hard**”
(As in “Hard Money” = Loss of deposit)
11. Longer time to COE

Financing

1. Source and amount of down payment?
2. What are your financial limitations?
3. Are funds available for emergencies, capital improvements, or income shortfalls?
4. Working with a commercial lender
 - Lenders minimize risk
 - Property must be self-sufficient
 - Scrutinize financials
 - Lending Criteria
 - The lesser of the two:
 - Loan-to-value (LTV)
 - Debt Coverage Ratio (DCR)
NOI/ADS > DCR

Due Diligence

- Books & records
 - Rent roll & accounting records or tax returns
 - Leases & tenant estoppel certificates
 - Receipts for expenses & capital improvements
 - Guarantees and warranties
- Building inspections
 - Walk-through
 - Roof
 - Commercial Property inspection
 - Termite, water, mold
 - Phase one environmental

“Talk is cheap.”

Remember...

- Primarily financial, less emotional
- Cap Rates or IRR critical
- Satisfy Investment Objectives
- Different disclosure requirements
- Different contracts & documentation
- Mistakes can be costly
- Highly litigious

Management & Disposition

Taking Title

- Protection through legal entities
 - LLC, LLP, S-Corp.
 - Pass-through taxation
 - C Corp.
 - Taxable entity
- Follow 1031 Exchange Rules
- Consult legal & tax counsel

Property Management

Hiring a Property Manager

- Typical Fees: 6% - 9% of Gross Revenue, plus maint. & repairs
- Interview & check references
- Manage your property manager: review books and building
- No waiver of liability – you are still responsible

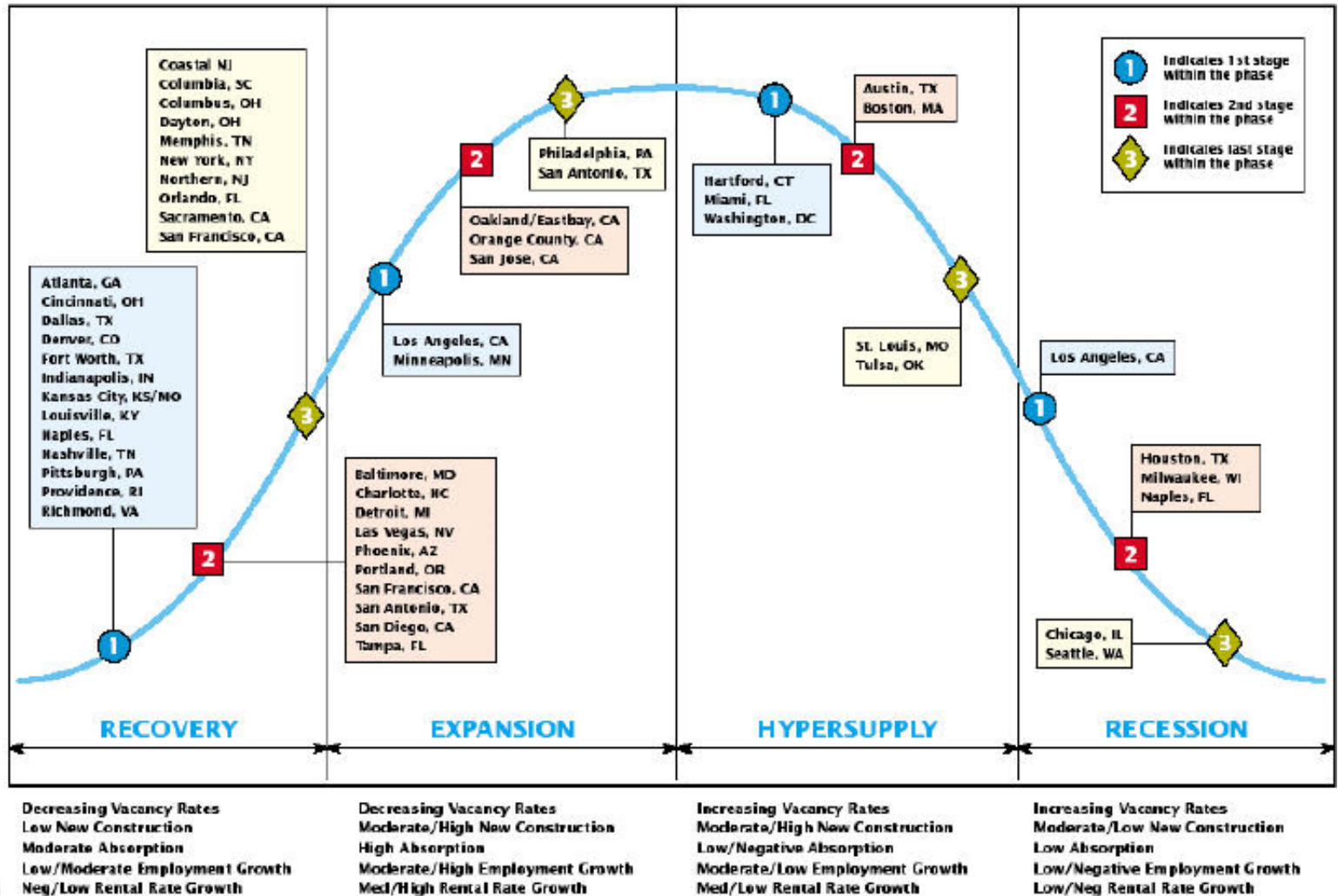
Self – Management

- You need experience or assistance
- Time consuming
- Must adhere to all regulations & contracts
- Different properties have different challenges

Selling Your Building

- Why sell
- Choose a disposition strategy
 - 1031 exchange
 - Seller financing
 - Cash out
- How to sell
- When to sell

RE Market Cycle



Good fishing...

But beware the sharks!



Financial Analysis Software

- Argus Edge / Argus
 - www.argussoftware.com
- Planease
 - www.planease.com
- Star Investment Analyzer
 - www.wanderingstar.com

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