The Family Office Guide to Commercial and Investment Real Estate

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i. Introduction

This book was written to demystify commercial real estate investments for the Family Office, by introducing you to many of the most important -- and most commonly misunderstood -- concepts of commercial property investing. In this book you will explore many aspects of commercial real estate and the key areas in both multi-family residential investment properties and non-residential investments. You will learn why real estate investment is so productive and in demand. You all already know the importance of a great location; however, now you will learn what few of you know: what makes a location great. You will learn how commercial property is valued, and you will understand the importance of operating expenses in relation to income. This book will teach you how to value commercial real estate and give you many valuable tips along the way. You will work towards a deeper understanding of how commercial property is financed, and how that financing is very different from single-family residential financing. You will explore comparable market data and learn how to use it, adjust it, and where to find it. We will dissect the sales transaction and teach you the anatomy of the commercial sales process; and you will learn to comprehensively consider options, and their impact on commercial investment. I am confident that after reading this book you will have the big picture about commercial real estate investing. This book will help you to be a much wiser - and, in the long run, wealthier - investor. I have tried my best to give you the most vital information you need to know when investing in commercial real estate. However, this is only a guide and must neither be construed as legal advice, nor construed as complete and comprehensive business advice, when investing. My hope is that this book will lay the foundation so that when you do get legal or business advice, you comprehend it completely. What's more important is that you know exactly what to do with it.

The vast majority of investors are well advised and well served to employ experienced, trained, and skilled brokers to guide them through the investment acquisition process. This book can serve you well to guide you in asking all the right questions when investing as well as helping to clarify the processes and key concepts. Commercial real estate investing will be challenging, will be fun, and will nearly always be rewarding.

1. Commercial Real Estate Described

What is Commercial Real Estate?

Let's start by defining commercial real estate. Generally speaking there are two main categories of commercial property: **multi-residential commercial property** and **non-residential commercial property**, each with many subcategories. You will be looking at multi-family properties first because this is the area where many investors begin their investment portfolios. Non-residential commercial property is real estate in every other form (except single family residential). The main categories of non-residential commercial property are: office, industrial, retail, hospitality, medical, civic buildings, and land zoned for commercial purposes. Later in this book you will be discussing office, industrial and retail properties. A brisk business is done in hospitality and increasingly, care facilities. The latter categories are highly specialized and most likely are areas that newer investors will leave alone until their real estate acumen develops. Office, industrial and retail properties cover the dominant portion of the non-residential market, and later you will go further into the attributes of these properties.

Multi-Family Investment Property

Multi-residential commercial property, or apartment buildings, break down into two sub categories, by size. For example, in most states, when someone buys four units or less, even if it combines residential and non-residential units, the purchase will be treated, legally speaking, the same as a purchase of a single family residential property. Consequently, it is subject to all the same disclosure and agency rules as a single-family dwelling would be. Seasoned brokers know the rules in their state, having learned them when they became licensed to practice.

Additionally, most lenders also view four units or less as a residential transaction rather than an investor-owned transaction. They therefore offer very different loan terms and conditions. Lenders look to the strength of the *buyer's* income and net worth when lending on these smaller properties (4 units or less). Whereas the lenders look to the strength of the income of the *property* when lending on larger properties. Larger commercial properties of all types are treated differently legally. This is because a purchase of that magnitude presupposes a greater degree of buyer skill and sophistication, and because the buyer will exercise a greater degree of due diligence when buying. Conversely, with the smaller units, there is a presupposition that the buyer might occupy a portion of the property as a primary residence and therefore needs the consumer protections afforded to buyers of single-family dwellings.

Understanding Leverage

Multi-Family Investment Property Sales is a highly competitive field often with too little product, too many brokers, a good supply of buyers, and few real sellers. That is because the stakes are high and real estate investment, over the long haul, is a high performing asset.

A great deal of the return on investment comes from **leveraged appreciation** of the **asset value,** which is normally based upon the income. Let me explain, in simple terms, what I mean, so you can plug in your local market numbers to create some real world examples. By **leverage,** I mean that the asset is being bought with only a portion of the purchase price coming from the buyer and the balance coming from a lender. The loan will be repaid by the occupants' rental payments to the new buyer. Therefore, any increase in value of the entire asset represents a **real return** on the original amount invested. The original loan will eventually be paid off by tenants and the investor will profit in the long run.

In very simple numbers it works like this: Suppose you contract to buy a ten-million dollar building, with 25% **down payment** and another 5% in **loan points, closing, and other costs** - all of which I will later outline for you in detail. You can readily see that the investor has $3,000,000 invested of his own capital at work. If the property appreciates or increases in value at 3% per year, the next year the building would be worth ten million three hundred thousand dollars, or $300,000 more than the investor paid for it. Since the investor has only $3,000,000 at work, the return on investment is the $300,000 gained divided by the $3,000,000 investment; or a 10% return on just 3% appreciation.

$$\text{*return on an investment} = \frac{\text{appreciated value - original value}}{\text{amount invested}}$$

* appreciation only

That is nice magic! If you add that to the **cash-on-cash return,** which is the spendable income the asset produces before income taxes and after all operating expenses and the mortgage payments are paid (and which I will explain more fully later), the total return on investment is even greater!

If, in our simple example, the **net spendable income** were another $20,000 the return would increase another 6.67%. Remember, you arrived at this by dividing the $20,000 by the $300,000 initially invested. Unless the loan is an **interest-only loan,** the realistic true yield is even higher: because not all of the **mortgage payment** is interest. Some of it goes to reduce the debt, which increases the **investor's equity position** in the property. Since the mortgage is paid from rents, it's a real return on investment for the investor that shows up when they sell or refinance. I give you this brief example to illustrate the importance of the stakes in this game of multi-family real estate investing.

We'll go into the financial aspects of this in greater detail later. Now let's look at some of the characteristics of multi-family investment property.

Investors buy apartment properties for income and rarely live in the property, except for smaller properties such as duplex, triplex and similar units. So then, in theory, just about any income-producing apartment should be fine for an investor; but of course you know that is not true. In many cases the physical aspects of an investment property are the best determination of how well the asset will perform financially. For example, older units are less desirable than newer units to the residents and tend to have higher vacancy rates and greater tenant turnover. Let's turn our attention to some important aspects of apartment buildings and their attributes so that you can better understand our market and better serve the needs of our future clients.