PETER HARRIS

COMMERCIAL REAL ESTATE *For* BEGINNERS

THE BASICS OF COMMERCIAL REAL ESTATE INVESTING

Commercial Real Estate for Beginners

The basics of commercial real estate investing

By Peter Harris

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Introduction

This is the story of how I got to where I am today…

I was born and raised in Northern California, graduated with a degree in Applied Physics and went to work as an engineer in Silicon Valley. With my good credit and some reasonable savings, I began buying single family homes. One day while renovating one of my houses to get it ready for renting and dog-tired from all the work, I had an "aha" moment. I thought to myself, "wouldn't it be great if I could combine all of my houses to be under one roof?" As my portfolio grew, the bills piled up on my desk and I dreaded having to cut all those separate checks. I also had been traveling from one rental to the other, dealing with my many tenants and their issues. I wondered, "What if all my rentals were in the same place?" Then it dawned on me that there was such a property, an apartment building!

The thought of owning an apartment building was frightening. Where would I get the money to finance the purchase? How do I manage something large? Converting my single family home portfolio into an apartment building seemed to be the best way to increase my holdings (without the headaches) but I was concerned about all the unknowns of owning commercial real estate.

About that time, I received a huge wake-up call one day at the engineering firm I worked for when my boss was laid off without him actually knowing. They wanted to replace him with someone younger and at a lower salary. The person they wanted to fill his position was me! Even though that had been my dream job since first joining that firm, I didn't take it. I couldn't. I reasoned that if they were willing to do that to my boss, they could easily do that to me too. I needed to create financial security for myself that no one could take away from me.

They say that when the student is ready, the teacher arrives. About that time, I had joined a mastermind led by Robert Kiyosaki, (who wrote what became one of the best-selling books of all time *Rich Dad Poor Dad*.) During one late night mastermind session, Robert was leading us in a game of liar's poker. It lasted for several hours and it got pretty intense. The game of liar's poker is designed to bring out the real you – which happens to be when you're facing adversity. And once we finished the last game, and I lost horribly, Robert gave us a stern debriefing. What he did shocked me, but in hindsight, completely changed my life.

He looked down at me and gave me the dreaded "loser" symbol ("L" shape thumb and finger on the forehead). That's right, he called me a loser and it shocked me to my core! My mentor, the man I looked up to, my hero, Robert Kiyosaki – called me a loser to my face. He said that games reflect behavior in real life, I was "playing it" too safe, not willing to play big and that I would stay the same mediocre person and end up with an average life if I did not wake up and see what I was doing. He was right. Absolutely right. That night I went back to my room and I broke down, realizing that if I was going to achieve all the goals and dreams I had for my life then I better start taking action and begin to play the big game that I knew I could play.

So when I returned home, I put up for sale two of my most profitable rental homes with the intent of buying apartments with the proceeds. That took some deep prayer and courage, but two things motivated me. First, I wanted to prove to myself that I wasn't going to play it too safe in my life any longer. And second, I no longer wanted to depend on my engineering job for my financial security.

Once my two rental homes sold, I diligently began searching for the right apartment deal. After scanning through nearly 70 available properties, I found a 45-unit apartment building a block away from a major university that seemed to fit my goals. The asking price was $775,000 and I ended up with a final price of $720,000 after two weeks of negotiating along with a $45,000 credit for renovations. The real estate broker that listed the property introduced me to several local banks, but since I was a first-time commercial real estate borrower in that city, I was declined by several of them. It was quite frustrating, but I eventually secured financing with a 20% down payment. Persistence and a nice-looking suit paid off!

The down payment requirement of $144,000 emptied my bank accounts. But the property still needed some fix up work so I asked the seller for cash rather than a $45,000 credit at closing. And I was able to get the work done for only $15,000 so that left me with $30,000 as cash reserves.

As I discovered, the location was ideal. Although it was a block away from a major university, it was situated along a street that was more fitting for graduate students and university workers than under grad students. Therefore, I wasn't renting to students which have a reputation of being management nightmares. As my mentors made so clear to me, location is critical in commercial real estate investing. You can fix a property, but you can't fix a location. The location of this property was terrific because of the jobs in the immediate area.

Choosing the right management company was so very important to me because I didn't want to be a professional landlord and I would only be visiting the property every few months due to its proximity to me. I choose a mid-sized firm to handle the management responsibilities. The mom and pop management companies were only proficient with managing single family homes and the large management companies were too expensive to use.

Kiyosaki taught me to figure out my "rat race" number, which was calculated as the bare minimum amount of money I need monthly to survive on, including paying rent/mortgage, insurance, food, gas, taxes, car, kid's school, etc. This amount did not include vacations or any other discretionary spending, but just a bare-bones number. This was the number that I shot for as a goal to meet and once I hit it on a consistent monthly basis, I would be out of the rat race.

I actually taped a piece of paper with the amount on my refrigerator as a daily reminder of what I needed to focus on. That's how focused I was! That's how bad I wanted it.

The two rental homes I sold cash-flowed a combined $1200-$1400 per month. The new apartment building I purchased, once the renovations were done and the vacancy rates were decreased, cash flowed $6,500 per month

I officially declared myself out of the rat race. Done. Finished!

You can't imagine the feeling I got when this happened. I felt so empowered. I was a single father at the time, and from now on when I picked up Jr. from school, I had a sense of security and confidence – that even if I lost, quit or got laid off from my engineering job, we'd be more than fine financially. Again, what I accomplished goes back to one decision I made. It seems that everything I wanted in life came down to one decision – to go forth – to take that leap of faith – to defy my culture – and to not settle, but go after the desires of my heart with no regrets.

The single biggest bonus I received from escaping the rat race was surprisingly not money-related. Let me explain. Ever since my son's mom left us, my friends helped get him to school and back each day, especially when I worked late or traveled overnight. I often wondered how much I owe them and how would I ever repay them? Well, to make a long story short, now that I didn't have to go to an office every day, I was able to drive my son and his friends to school every day until high school started. The joke amongst all us parents was, "why is Mr. Harris (me) so happy every morning and smiling when he picks up our kids every day. And he's always in his pajamas". Little did they know…(smile).

I then sold off my other single family homes and purchased 2 more small apartment buildings. Then I ran out of down payment money for more properties and along with advice from my mentors, I began raising private money so that I could acquire even more property. And I've been on this amazing journey ever since and it seems to get better every year.

After getting out of the rate race, I helped a friend purchase his first 4-plex and office space. After his experience, he suggested, “Peter, you should start teaching people how to invest”. I brushed it off as simply a kind word of thanks. Then I helped a fellow engineer buy two small apartment complexes. These two investments gave him the courage (and cash flow) to leave the company I used to work for and start his own engineering firm. He also encouraged me to start coaching and mentoring others on commercial real estate. And that’s when it dawned on me that I may have a talent for teaching others on the subject.

A true passion of mine, I discovered, is teaching people how to be successful investors. Even as a small child, I loved helping the underdog and watching them beat the odds and do what others said couldn’t be done. Eventually, I was teaching people all over the US and one of my students who worked for the marketing department of Donald Trump told him about the successes he had working with me – and that’s how I got to co-author a product with Donald Trump himself. A few years later, a major book publisher saw the type of commercial deals we were putting together with our students and asked me to write a book for beginning commercial real estate investors. That’s how I got the opportunity to author *Commercial Real Estate Investing for Dummies*, a best-seller now. That’s why mentoring people is so much fun for me – I get to see people grow from owning zero investment real estate to all-of-the-sudden, owning several acres of income-producing real estate. And what it does to their lives – financially, retirement-wise, and personally, is very, very rewarding. And I believe that’s what I’m called to do in life. Serve people. Teach people. Help people get ahead. That's my passion.

One such person I mentor today is Joe. He was an account manager for an advertising company in Manhattan, in the heart of New York City. He needed a way to replace his income since his firm was soon to be downsized. He had dabbled in single family rentals, but after 3 years, he knew he needed something with more potential. Through my tutelage, Joe found a motivated apartment owner of a 168-unit apartment complex who was in his mid-70s and ready to sell and move back to his home country of Greece. Joe had several obstacles to overcome; namely, he had only $50,000 in savings and had no previous commercial investing experience. In a few weeks, I coached him on how to raise the down payment needed which was $1.3MM. He raised the entire $1.3MM in about 60 days. He structured the deal with a master lease agreement since it works for buyers with no experience, with lack of a down payment, and where no banks are involved. The master lease was structured for 4 years. After 4 years, he'll have to refinance the current loan into his own company name. Joe's out of pocket expenses were for property inspections, appraisal, attorney fees, and travel costs – about $32,000. Joe closed on the deal and left his job. The property was appraised for $7,000,000 immediately after closing, giving $400,000 in instant equity. I also had Joe negotiate that he would be credited for the pay-down of the loan balance, which will be approximately $800,000 over the next 4 years. Joe saw the wealth-building power of commercial real estate right before his eyes. Although there were many great things about Joe's deal, the best in my opinion is that it took only one deal, one commercial deal, in order for Joe's life to never be the same. The second best part of this whole deal from start to finish is that Joe could have been anyone – including you. Joe now has time to work on his next commercial project – building a $9MM commercial building from the ground up.

And my story continues as today. I have the awesome privilege of coaching and mentoring people from all walks of life in just about every state through the Protégé Program found at CommercialPropertyAdvisors.com. Engineers, sales managers, post office workers, small business owners, physicians, chiropractors, route drivers, stay-at-home moms, airline pilots, real estate agents, insurance agents, police officers, stock brokers, school teachers, attorneys, homebuilders, and the list goes on as to the incredible people I have helped buy commercial real estate successfully.

This book is dedicated to those who want more and are now ready to go get it; to those who were told "*you can't do that*"; to those who know deep down they can do better than what they're doing now, and to those that dare to believe that their best is yet to come no matter what age, race, gender, or family you are from. Let's do this!

Chapter 1
Definition of Commercial Real Estate

Commercial real estate can be defined as…

The term commercial real estate is a broad term. It generally refers to any property other than a single family home or a residential lot in a neighborhood. If real estate makes money, is rented out, is for investments, or falls into a number of other categories other than being a private residence, it can be considered commercial real estate.

- The term commercial property (also called investment or income property) refers to buildings or land intended to generate a profit, either from rental income or capital gain.
- The business of selling or buying properties such as office complexes, industrial plants, apartment complexes, and retail properties.
- Any real property **except** a property with only one to four dwelling units for residential use. Any property mixed with both residential and commercial.
- Real estate used in the operation of a business. Commercial real estate can be leased or owned and may include a wide variety of property types, such as apartment buildings greater than 5 units, office buildings, retail space, and industrial facilities.

Here is a quick list of typical commercial real estate that you see every day:

- Office buildings
- Apartment buildings great than 5 units
- Retail shopping centers
- Medical offices
- Self-storage facilities
- Industrial complexes
- Warehouses
- Mobile home parks
- Hotels, motels, resorts, and the list goes on…

It's basically where businesses are conducted or it's where people live together. Commercial real estate is everywhere.

Understanding commercial real estate is essential since there may be different rules that apply to commercial versus residential real estate. For example, qualifying for a commercial mortgage may be different from qualifying for a personal mortgage, since in many cases your ability to get a personal mortgage is based solely on your income while your ability to get a commercial mortgage may be based on the income that is generated or expected to be generated by the property. There may also be different tax rules for a commercial property versus personal property and such properties may be treated differently in the event of bankruptcy.

Commercial real estate is also…

Commercial real estate is also a way of generating real **long-term wealth** that pays you every month and potentially increases every year. As an investor, you can create a perpetual means of **passive income** for yourself – tax-advantaged income that could last for the rest of your life and your kids' lives.

We know of no better investment strategy than commercial real estate to help you get out of the rat race and stay out while creating generational wealth.

Chapter 2
Reasons to Invest in Commercial Real Estate…

Warren Buffet, arguably the greatest investor of all time, has given us a model for *how* to invest and *why* we invest in commercial real estate. Published books from his past partners and family members all have a common theme to Warren's #1 rule:

> *"Only invest in things you have an understanding of."*

His advice is quite simple and an easy recipe to follow. When Warren understands something and then invests in it, he achieves two major critical objectives:

#1 Predictability
#2 Control (actually six controls)

Warren studies his investments so well, that he can very well predict what's going to happen. That is actually his key to success and massive wealth. Warren's intimate knowledge of an investment allows him to know when to wait, when to buy, when to hold, when to partner, and when to sell. You'll soon learn in commercial real estate, that you can do the same.

Also, when Warren buys a company, he negotiates and gets control of the company. He gets control over 6 parts of a company that are the life and blood of any successful company. They are: income, expense, asset, debt, management, and insurance. Commercial real estate investing offers you these same 6 controls as well.

1 – You control the *income* by raising rents

2 – You control the *expense* because you're calling the shots

3 – You control the *asset* because you can sell it or refinance whenever you want

4 – You control the *debt* because you're the one who arranged financing

5 – You control the *management* because you hire the property management

6 – You control the *insurance* by choosing the type and level of insurance desired

Having **predictability** and 6 **controls** are true benefits in commercial real estate investing.

Your First Commercial Deal?

Let's pretend this is you. You're in your mid-50s. You have retirement savings, but surely not enough to retire on. You inherited a single family several years ago. Your step sister had lived in it since, but now has re-married and is ready to move on to live with her husband. You put the house up for sale. The real estate agent listed the house for $360,000. You now have to decide what to do with your sales profits. Savings? CD? Stocks and mutual funds? Buy a business? Or invest it in real estate? After a few weeks of pondering those questions, you decide to invest it in an income-producing property. To make a long story short, you end up purchasing a 32-unit apartment complex not too far from your own home. You hire a professional property management company to oversee the property. The investment brings in about what you earn in a year from your day job. By next fall, you plan on working on a part-time basis to pursue more real estate investing. End of story (thus far!)

Let's examine the benefits of which commercial real estate investing brought you:

• **Probably the most important benefit for you is that now you have *options*.** By creating a cash-generating business that your boss has no control over, if you were laid off or fired, income to pay your living expenses still exists.

• **You can force the appreciation.** You have some control over the appreciation level of your property. As you raise rents, the value of your commercial building goes up since the net income has increased.

Automatic Equity Build Up: As the mortgage is paid down (thanks to your tenants rental payments), your equity in your property grows automatically.

• **You have a good hedge against economic volatility.** If the real estate market has a downturn, you can lower rents to keep the building full. When the economy turns around, you can raise the rents and ride the wave to higher cash flows.

• **You have an excellent tax shelter.** Rental income from real estate is extremely tax advantaged. The main reason is due to a wonderful piece of IRS code called "Depreciation". It is not an out-of-pocket expense, but still a deduction against your net income on your taxes. This allows you to pay much less in taxes than your ordinary income from your day job.

• **Leverage and velocity: two powerful wealth-building words.** Would you rather own 50 homes or a 50 unit apartment building? With 50 homes, you'll need to obtain 50 loans, 50 appraisals, 50 closings, take care of 50 roofs, mow 50 lawns...get the picture? With 50 units, you'll have one loan, one appraisal, one closing, one roof, and one lawn to deal with. Which do you think would be easier and quicker to sell? 50 homes or one 50 unit building? From the management point of view, is it more efficient to manage 50 separate homes or 50 homes under one roof?

• **You have no day-to-day management on your part.** Wouldn't it be great if you could reap all the benefits of ownership (cash flow, appreciation, and tax advantages) without having to do any work? Well, if you hire a good manager or management company, that's what happens.

Create Instant Wealth with Forced Appreciation & Equity

Force Your Property To Be Worth More by…

Increasing the rents of your tenants. One of the main ways a commercial property's value is determined is by its net operating income. Therefore, the higher the net income, the higher your property value is. It's that simple. Raising rents and lease rates is by far the simplest way to do so.

Decreasing operating expenses of the property. Think of a commercial property as a business that sells products. If you can reduce the cost of the product you sell while maintaining the same price, then your profit is greater. The same applies to the value of your commercial property. If you can reduce the cost of operating it, but maintain the same rent and lease rates, then you're more profitable, right? Typical operating expenses that one can reduce are the following: employee expenses, contractor usage, utility usage, office expenses, property tax assessment, insurance, etc.

Giving the property a facelift – inside and out. Making improvements to your property cosmetically or by rehabbing it, will not only increase the property's *perceived* value, but "handsome" properties can charge higher lease rates and rents. Giving your office complex a new front façade and remodeling the lobby will give your tenants a boost of prestige. This will allow you to raise your rents on new tenants coming in and set you up for higher rents when lease-renewals come up.

Changing the property's highest and best USE

My friend Linda inherited a large warehouse that was used as a plastic garbage can distribution center. The business closed up shop and an empty building was all that was left. It sat near the wharf behind a tourist-heavy shopping center. Linda went to the city planner's office and sure enough, it was the city's desire that the warehouse land be used for more retail shopping. She saw the potential and approached a few shopping center developers. In short order, Linda had the zoning changed from "industrial" to "commercial-retail" and soon work began on converting the warehouse to a glass-ceiling indoor mini-mall, while keeping the unique “industrial warehouse” look.

After 2 years since the plastic business closed doors, Linda is now majority owner of a bustling mini-mall sporting over 30 stores and open 364 days of the year. She kept one space to herself and opened a store dedicated to the development and improvement of self-image and self-esteem of young girls and women. Changing the property use not only significantly changed the value of the property and made Linda millions over, but it’s going to significantly impact a great number of young woman’s lives as well. Win-win!

Adding amenities…smartly

Many of the large apartments we’ve been involved with have swimming pools. So, adding a swimming pool is no big deal and it may be more of a hassle than what value it brings in some cases. We network with other property owners and share “best-practices” with each other to learn what the latest “in” thing to do to wow our clients, our tenants. Throughout the years, this is what we’ve learned to increase our property values, our client’s property values, and the neighborhood values: a business center with computers (bolted down, of course!), fax machine, copier; a conference room to hold meetings; a fitness center with trainers available for hire, free wireless internet especially near universities, a cutely accented coffee bar (we copied the Starbucks theme); and concierge services. Now, obviously not every property has these amenities. Because these items take money and time to plan out and construct, we constantly look at the costs and benefits of each as they are used (or not used in some cases).

The goal here of course is to provide our tenants with a unique experience and well-thought service they could not get anywhere else, at least in our neighborhood.

As for a direct cash-generating amenity, consider putting a coin-operated laundry facility onto the property. If it's near a college campus, accessible, and well-marketed, it can be a cash-flow factory. For office building, consider charging for parking or valet parking. For self-storage, there are plenty of cash generators you can add to enhance the experience of your visitors and tenants.

Chapter 3
The 7 Habits of Highly Successful Commercial Investors

I really believe it is a smart thing to study others who are successful in the field you desire to be successful in. Don't you? With that said, I have observed, experienced, and gathered seven wealth-building habits for commercial real estate investors. Pay close attention to them as some of them are counter-intuitive to traditional real estate training and investing.

Habit #1 – They Only Invest in One Asset-type at a Time...The Power of Focus!

- The best and the brightest shopping center owners are the best and brightest at one thing – investing and operating shopping centers. The same goes for the best large apartment operators that are at the top of their game. They don't stray away from their specialty, but rather focus on one asset-type at a time. They don't try to be "jack-of-all-trades". Neither should you, if you want to be one of the best and brightest. Focus plus follow-through brings about quantum results. Focus, focus, focus…!!

Habit #2 – They Don't Over-Leverage DEBT…

- Heavy debt is a cash-flow killer. Even though debt is pretty much the norm on most deals, be smart about it. Having high debt is a trap that snares cash-flow and equity.

• An easy way of measuring your "debt-safety" level is to figure out your break-even/occupancy percentage. To do this quickly, simply add up all of your annual operating expenses plus all your debt. Then, divide that number by your potential gross income. You'll find that your operating expenses will typically not vary much, but that your debt can have a huge impact on your break-even point in occupancy. The higher the debt load, the higher the break-even point in occupancy needed. For example, if your break-even occupancy point is calculated to be 60%, then, after that, it's all cash flow. But, if your calculation comes out to be 90%, that spells trouble. You have no room for error and must keep your property 90% occupied just to pay the bills.

• Having 50-60% debt (or 50-60% LTV) on your properties is ideal and not easy to achieve, but it will keep you out of trouble and allow you to enjoy greater cash flow and less risk.

Habit #3 – Their Properties Are Managed Effectively and Professionally

• Having top-of-the-line property management, whether you do it yourself or hire a company to do it for you, is a major key to success.

• In a nutshell, a top management company's ultimate goal is to maximize potential rental income, reduce operating costs, strengthen tenant retention and relations, enhance visual appeal of the property, and increase property value. If they can do this, you have a winner.

- Commercial properties that have the best reputation in the community have the highest rents, the lowest turnover, and have sound and solid property management.

- Good property management has well-oiled systems of accountability for the 4Ms: money, marketing, maintenance, and managing the staff.

Habit #4 – They Patiently Acquire and Have Tolerance for Mistakes

- Rome was not built in a day. Building a good-sized and wealthy portfolio requires years to build and is built one property at a time. Successful commercial property owners take their time and strategically plan out their acquisitions over a period of years. The real estate cycle and market conditions have to be just right in order to make the best buying/selling decisions. Time and timing are the keys. The average real estate cycle is ten years in length, so give yourself at least that to build your Rome.

- Have you noticed that life tends to have built-in provisions for the mistakes we make? The most successful commercial property owners whom I personally know made huge mistakes in the past that have brought them literally to their knees, but the most successful ones bounced back to do even bigger deals. The moral of the story is…it's human to make mistakes, but it is also human nature to be an overcomer.

- Allow yourself room and grace to make mistakes. It is the highest form of learning there is.

Habit #5 – They Effectively Partner

- Throughout history, no one has achieved impossible dreams or built amazing companies without effective partnering and/or outside advice. When you really think about it, there is no such thing as a self-made millionaire. Somebody somewhere at some point helped or advised that person.
- The commercial investment business can be very dynamic with lots of moving parts to it. Don't be average over a lot and master of none. Do what you do best and hire out the rest to the best.
- Successful commercial property owners know the value of relationships. Success is a relationship business. Finding the best deals, solving the biggest problems, and finding the money for your deals come from relationships.

To learn how you can effectively partner with the author of this book, go to www.commercialpropertyadvisors.com

Habit #6 – All Their Business Systems Are Accountable

- Well-run and profitable commercial investments seem to go under the radar. But what you will hear more of are the properties that are failing or are in deep trouble. Upon deep inspection, you'll find that the troubled properties have a key component to their operation that has stopped working (or has never worked). And that failed component has caused, or will cause, other facets of the operation to fail down the line soon. Nonetheless, a profitable commercial investment business has nearly every business component running at good to satisfactory levels.

• Successful commercial property owners have excellent internal communications and accurate financial and operational reporting. Their systems allow them to hold their business systems accountable to those responsible. Here is a sampling of typical commercial property business systems: accounting, revenue, internal controls, property staff, marketing system, maintenance, and marketplace.

Habit #7 – They Are Well-Insured and Their Entities Are Set Up for Maximum Protection, Privacy, and Tax Strategy

• "Plan for the worst and be happy if it doesn't happen" is the attitude and habit of the most successful commercial property owners.

• Their goals are to build a legal fortress with strategic and intelligent insurance coverage and with the use of well-thought out entities such as LLCs, LLPs, Corporations, TICs, Trusts, etc.

• A poorly protected investor may not only lose his or her properties to a real or frivolous lawsuit, but personal property as well. There are over one million attorneys in the U.S., all wanting to deploy their skills (on your property!).

• Before doing any of this on your own, consult an asset protection attorney and tax strategist first.

7 Commercial Investing Myths

Myth #1 – You need to be a millionaire and have good credit to get started

Truth – Master lease techniques is one of the many ways of buying commercial real estate with a reasonable down payment but not involving a bank (no credit required).

Myth #2 – Analyzing the numbers is too difficult

Truth – Can you add up rents? Can you add up expenses? Can you use a mortgage calculator? If so, that's all you need to calculate the most important figures in commercial real estate.

Myth #3 – Property management is the key to success

Truth – Yes, this is a myth! A very important word was left out that would turn this myth into truth: ***effective****. Effective property management is the key to success. Not just any ol' property manager will work! You'll learn that 9 out of 10 property managers are no good and how to find and keep the best in the business.*

Myth #4 – It's a good idea to park your money in a down market

Truth –First of all, if you are not a student of investing, then it is wise to park your money in a down market. Never invest in anything you have no knowledge of. But if you have been in the investing game, you know that the best opportunities are around when the market is mostly down. As Warren Buffet quotes, "Buy when there's blood in the streets!" Actually, there is no bad time to invest – if you're skilled enough, you'll have great deals to buy. You'll discover that the business of commercial *real estate is a "relationship" business. And so long as there are people, good people, you'll have good deals!*

Myth #5 – All the good deals are gone

Truth – As long as people believe in this myth that just leaves more deals for you and I!

Myth #6 – Investing in commercial is too risky

Truth –Never invest in anything you don't understand. Your next investment is only as risky as your level of understanding in whatever you're investing in. If you have no knowledge of something you want to invest in, then it is risky. Go get the knowledge. Get help. Why would you make the biggest dollar investment of your life without any trusted mentors and advisors to guide you?

Myth #7 – I can't invest in commercial while having a full-time job

Truth –We recommend for you to have a full-time job when you get started so that your cash flow to pay your living expenses is there. As your portfolio grows, you'll find that your job will start to get in the way of your investing. Although you won't find a perfect time to leave your job, you'll know when it's time. Do the smart thing – have your passive income from your investments at least match your take home pay before planning on leaving your job. Get help from people who have already been there and done that.

Chapter 4
10 Opportunities to Invest In Commercial Real Estate

Apartment complexes (5+ units)

This commercial property category includes everything from small apartment properties (five units plus) to large apartment communities that span several city blocks. You drive by these types of commercial properties every day. Every apartment building you drive by is owned by some type of commercial investor who's in it to make money. What we find great about in investing in apartments is that they're easy to find, everyone needs a place to live, banks love to lend on them, and they're great cash flow generators.

The advantage of starting off with apartment properties is that they're a great way to jump into the exciting world of commercial real estate investing. Most commercial investors we know, start off by investing in small- to medium-sized multi-unit properties.

Great reasons to invest in apartments include:

- Everyone needs a place to live
- Tremendous cash flow potential
- There are many apartments to choose from to invest in
- Apartments are the bank's favorite to lend money on
- Easiest to sell compared to other types of commercial real estate

- Excellent asset to invest in when economy is most volatile

What's driving the demand for apartments?

Echo-boomers are driving the demand to keep apartments full for years to come. Echo-boomers, Generation Y, or Generation Next (all the same) are defined as people born between 1982 and 2002. NAHB (National Association of Housing Builders) chief economist believes that 83 million echo boomers entering the market over the next decade is a positive demographic trend for the apartment rental market. This trend is going to drive the longer-term improvement in apartment fundaments. Echo boomers affected by the housing and financial crisis are going to be biased towards renting over ownership making rental properties valuable. They prefer the life of tenant to home ownership making apartment ownership valuable for landlords.

Office buildings

The office building or warehouse you're sitting in right now is owned by a person just like you and me. As time goes by and your city grows, more and more office buildings are being built. One of the most enticing methods of investing in office buildings is by way of *triple net leases.* This type of lease is one where the tenants in the property pay you the rent plus they also pay for the following:

- Any kind of property maintenance, upkeep, and repairs
- The property's taxes and insurance

This is the true meaning of *passive income*. In most cases, you'll hire a property management firm to keep the building full of tenants, handle all tenant issues, and pay the bills (plus sending you your check every month).

Triple net leases are so called because all three categories of expenses are paid for by the tenants in your office building. Tenants pay all three of these costs so that the rent you get is a net amount that you don't have to pay expenses out of. So, after the tenants pay for all of the expenses and you pay the mortgage, the rest goes into your pocket. Lastly, it's quite typical for a triple net lease to be five to twenty years in duration with rent increases every few years. But that could be a disadvantage as well and here's why. Let's say that the lease is for ten years. If your neighborhood experiences explosive growth over the next three to five years, you won't be able to charge higher rents or capitalize on what's happening because you're locked into a ten year lease agreement. But overall, triple net lease investments are very much sought after.

Retail and shopping centers

Retail centers, shopping centers or malls, are at the center of most towns and cities in our country. These are the places where people come to shop, eat, and meet with friends. Most investors like retail centers because, like office properties, many retail properties are leased out on a long-term triple net leases where the tenants pay for all of the expenses. The upside to this as an investor is that your rates of return won't go down over time as the taxes and expenses go up. In fact, as rents go up over time, your returns just keep getting better and better. And as in most triple net lease agreements, rent increases are built into the agreement with the tenant.

Let's quickly explore the different types of retail and shopping centers that exist and some familiar terms you probably have already run across:

- **Anchor tenant** - Usually the first, and the leading, tenant in a shopping center whose prestige and name recognition attracts other tenants and hopefully, shoppers.
- **Power center** - is an unenclosed shopping center with leasable area that usually contains three or more big box retailers and various smaller retailers (usually located in strip malls) with a common parking area shared among the retailers
- **Big box retailer** - is a physically large retail establishment, usually part of a chain. Examples include large department stores such as Wal-Mart and Target.
- **Strip center** - A shopping area made up of a row of retail stores traditionally anchored by a supermarket.
- **Credit tenant** - tenants that are usually publicly traded or large private entities with a strong S&P credit rating.
- **Mom and Pop tenant** - the saying says it all, these are small businesses in small square footage
- **Pad site** - A single freestanding retail site, often adjacent to a mall or larger shopping center. An example would be a photo kiosk, a burger stand, or a drive-thru gourmet coffee shop.

Self-storage facilities

Let’s face it, Americans keep a lot of stuff and they need somewhere to keep their stuff. When their stuff outgrows their homes and businesses, they turn to self-storage facilities. According to the Self Storage Association (SSA), self storage has grown into a $220 billion industry.

A slow housing market can actually help storage facilities, according to industry analysts and local facility operators. As the housing market slumps, people downsize their house sizes, and need a place to store their extra stuff. Many use self-storage facilities to store their RVs, campers, boats, classic cars, and snow mobiles. Businesses use them as warehouses too. Today's typical storage facility may comprise several one or two-story buildings on 2 to 6 acres of land, or a multiple-story building, containing a carefully designed unit mix of spaces. The units typically range in size from 5 x 5 to 10 x 30 feet with 30,000 to 120,000 total rentable square feet of space.

The typical self-storage investors will enjoy the following perks:

- No tenants to deal with on a daily basis and no toilets to fix
- Minimum income collection issues – tenant payments are automated and non-paying tenants are locked out.
- You have multiple profit centers under one roof – sale of boxes, moving supplies, locks, billboard leases, and the list goes on…
- Low risk – no single tenant move-out will greatly affect your cash flow

Industrial Properties

This asset-type usually falls into 3 categories: manufacturing, light manufacturing and assembly, and distribution. Warehouses, commercial condos, distribution centers, assembly plants, office/workspaces, art studio, workshops, showroom are all examples of industrial real estate.

Experts predict that we'll see less and less warehouses as time go on and technology continues to grow by leaps and bounds. With the development of bar-coding, inventory control systems, improved stacking and warehouse handling equipment, industrial space has become very expensive to maintain as it is used. The question is often asked, is the land (space) a lot more valuable when used for another purpose? What happens if on the same land as the 20,000 square foot warehouse stands, you built a 36-unit apartment complex?

However, industrial real estate opportunities will always be in almost every metropolitan area, concentrating in major transportation hubs. With these areas, it is critical to be as close as possible to transportations facilities since shipping times means money, and the ability to get goods in and out of storage is often critical between both the shipper and the receiver.

Hotels and motels

Hotels and motels are a different animal. Let me explain. Once you buy a hotel/motel, you buy the property and a 24-hour-a-day 365-

day-a-year business. This business requires hard work and marketing skills to keep the rooms constantly filled. The rooms are worthless if they are vacant. The business tends to be seasonal and may be affected immediately by economic downturns and political events, e.g. 9-11. Many of the businesses are family-run due to its very dynamic and intense management requirements.

Hotels and motels are not the easiest place to get started, but many experienced investors have found it to be a highly profitable niche.

Mobile Home Parks

Mobile home parks, trailer parks, manufactured homes, it's all the same. Look at these commercial investments as two pieces – one, the land, and two, the home that sits on it. Wouldn't it be great to own the land and just rent out the spaces (called pads) to the owners of the mobile homes? That way, you have no roofs, no toilets, and no utilities to mess with it. That's as passive as you can get.

Most mobile home parks are owned and operated by "mom and pop" investors and these investments are usually a combination of the land and the mobile homes themselves. Although banks will readily lend on the land, rarely do they want anything to do with lending on the mobile homes. Therefore, typically sellers of mobile homes offer seller financing in order to help a new buyer with funding the purchase. Most mobile home park investors provide a very sizable down payment to the seller and then use bank and seller financing to fund the rest of the purchase. And although some people snub their nose at this commercial property type opportunities are many in this niche.

Here are 3 great advantages for owning mobile home parks:

- Mobile home parks can range from 10 to 20 acres. As a result, the land becomes so valuable that eventually those homes are replaced by retail or residential real estate. But in the meantime, the mobile home park is creating an incredible cash flow because in essence you are renting the dirt that the mobile homes sit on - so you are leasing the land to people - which makes it a very attractive investment.
- There is a minimum amount of maintenance required. By leasing the land to residents, you have very little maintenance needed.
- There is also the possibility for many profit centers. For example, there is the option to bring in homes to provide tenants with a lease option. So you are not only leasing the land, but you are selling the mobile home on terms as well.

Special Purpose Properties

Special purpose properties are commercial real estate designed for a specific purpose in mind. They include restaurants and gas stations, for example. Brand name restaurants like **McDonalds** and **Burger King** are single tenant properties with long term triple-net leases which often require no management responsibilities from you, the investor. Here's how it works: The restaurant operators sell the property (not the business) to investors and lease back the property for 20 years. They in turn use the sale proceeds to expand their business by building more restaurants. You, as the investor (landlord) can expand with them, buying and owning the property while being paid handsomely with zero restaurant business opportunities.

Let's discuss **gas stations**. When you buy a gas station, you buy both the property and the gas station business. Most gas stations also have convenience stores and sometimes several car repair bays. The profit margin for gas is fixed at 10-20 cents per gallon. This is considered an owner-occupied property which qualifies you to a SBA loan with as little as 10% down payment is required. If you don't plan to get involved in running the gas station, auto repair and convenience store business, you may want to stay away from gas stations as gasoline is a chemical that could contaminate the soil. Once a leakage occurs and contaminates the environment, it takes years and lots money to clean up the soil. You may even be liable to damages from owners of adjacent properties as contamination may spread out to their properties. It's almost impossible to sell your property as no lenders want to loan the buyers the money to buy it. So, buyers beware!

Commercial REOs

Commercial REOs ("real estate owned") are commercial properties that banks have foreclosed upon, now own, are available for you to purchase, and at times can be acquired at large discounts. Banks are not in the landlording business and don't want to be. By selling off their REO portfolio of properties, the banks free up cash to lend on "higher performing" properties. Although commercial REOs are not a property-type, they are very much commercial opportunities you should pay attention to. It is not unlikely to purchase REO commercial property for pennies on the dollar. For example, I have seen fully occupied $2 million dollar retail strip centers sell for $750,000. Now that's how you build significant wealth. The ideal way (to get the best deal) to purchase commercial REOs from banks is to come prepared to pay all cash.

Commercial Short Sales

Commercial short sales work very much like residential short sales. A short sale occurs when the amount owed on the property, or the loan, is more than the current value of the property. The bank that holds the loan has to agree to let the current owner of the property sell the property for a steep discount to a new buyer thereby "shorting" the loan. This is done to keep the property from going into foreclosure.

You know the saying, "another man's trash is another man's treasure"? Well, this is how you make significant profits using short sales as a strategy. A property that is ripe for short-selling will be in the "distressed" category. Therefore, you, as the new owner, will have to overcome potential issues such as catching up on repairs, low occupancy, and poor property management. The upside potential on most short sale commercial opportunities can be huge if done right. There are no limits on the amount a commercial property can be short-sold nor are there any limits on the type of commercial property that can be. The sky's the limit here!

REITs

For many people, investing in real estate, particularly commercial real estate, is simply out of reach financially. But what if you could pool your resources with other small investors and invest in large-scale commercial real estate as a group? REITs (pronounced like "treats") allow you to do just that.

REIT stands for **real estate investment trust** and is sometimes called "real estate stock." Essentially, REITs are corporations that own and manage a portfolio of real estate properties and mortgages. Anyone can buy shares in a publicly traded REIT. They offer the benefits of real estate ownership without the headaches or expense of being a landlord.

Investing in some types of REITs also provides the important advantages of **liquidity** and **diversity** (unlike actual real estate property, these shares can be quickly and easily sold). And because you're investing in a portfolio of properties rather than a single building, you face less financial risk.

REITs came about in 1960, when Congress decided that smaller investors should also be able to invest in large-scale, commercial real estate. It determined that the best way to do this was the follow the model of investing in other industries -- the purchase of *equity*.

A company must distribute at least 90 percent of its taxable income to its shareholders each year to qualify as a REIT. Most REITs pay out 100 percent of their taxable income. In order to maintain its status as a **pass-through entity**, a REIT deducts these dividends from its corporate taxable income. A pass-through entity does not have to pay corporate federal or state income tax -- it passes the responsibility of paying these taxes onto its shareholders. REITs cannot pass tax losses through to investors, however.

From the 1880s to the 1930s, a similar provision was in place that allowed investors to avoid **double taxation** -- paying taxes on both the corporate and individual level -- because trusts were not taxed at the corporate level if income was distributed to beneficiaries. This was reversed in the 1930s, when passive investments were taxed at both the corporate level and as part of individual income tax. REIT proponents were unable to persuade legislation to overturn this decision for 30 years. Because of the high demand for real estate funds, President Eisenhower signed the 1960 real estate investment trust tax provision qualifying REITs as pass-through entities.

A corporation must meet several other requirements to qualify as a REIT and gain pass-through entity status. They must:

- Be structured as corporation, business trust, or similar association
- Be managed by a board of directors or trustees
- Offer fully transferable shares
- Have at least 100 shareholders

- Pay dividends of at least 90 percent of the REIT's taxable income
- Have no more than 50 percent of its shares held by five or fewer individuals during the last half of each taxable year
- Hold at least 75 percent of total investment assets in real estate
- Have no more than 20 percent of its assets consist of stocks in taxable REIT subsidiaries
- Derive at least 75 percent of gross income from rents or mortgage interest

At least 95 percent of a REIT's gross income must come from financial investments (in other words, it must pass the **95-percent income test**). These include rents, dividends, interest and capital gains. In addition, at least 75 percent of its income must come from certain real estate sources (the **75-percent income test**), including rents from real property, gains from the sale or other disposition of real property, and income and gain derived from foreclosure of property.

Here's a look at the different types of REITs:

Types of REITs

Let's start with the three REIT categories: **equity**, **mortgage** and **hybrid**.

Equity REITs (EREITs) purchase, own and manage income-producing real estate properties such as apartments, shopping malls and office buildings. Equity REITs are different from typical real estate developers because they purchase or develop real estate to operate it as part of their portfolios instead of developing it for resale. Equity REITs are considered superior for the long-term investing because they earn dividends from rental income as well as capital gains from the sale of properties.

Rather than investing in properties, **Mortgage REITs (MREITs)** loan money for mortgages to real estate owners or purchase existing mortgages or mortgage-backed securities. Their revenue is generated primarily by the interest that they earn on the mortgage loans. Mortgage REITs react more quickly to changes in interest rates than equity REITs because their dividends come from interest payments. Today, there are close to 40 mortgage REITs. Of these, about 25 invest in residential-mortgage securities and the rest invest in commercial mortgages. Mortgage REITs are considered a good speculative investment if interest rates are expected to drop.

As their name suggests, **Hybrid REITs** are a combination of equity and mortgage REITs. They both own property and make loans to real estate owners and operators. Hybrid REITs earn money through a combination of rents and interest.

Some REITs are established for a single development project and set up for a specific number of years. At the end of that time period, the REIT is liquidated and the proceeds are distributed to the shareholders.

There are also classifications based on whether or not the REIT can issue additional shares. If the REIT is a **Closed-end**, it can only issue shares to the public once and can only issue additional shares, which dilutes the stock, if current shareholders approve it. **Open-ended REITs** can issue new shares and redeem shares at any time.

Although some REITs have a broad focus and invest in a variety of property types in a range of locations, many REITs focus their investments either geographically or by property type. An individual REIT may hold properties only in a specific region, state, or metropolitan area. Or, it may hold properties across broader geographical areas but focus on healthcare facilities, apartments or industrial facilities.

The National Association of Real Estate Investment Trusts (NAREIT) divides REITs into three classifications based on how they can be purchased: **private**, **publicly traded** and **non-exchange traded**.

Private REITs are not registered or traded with the Securities and Exchange Commission (SEC) and raise equity from individuals, trusts, or other entities that are accredited under federal securities laws. Private REITs generally are subject to less regulation, with the exception of guidelines associated with maintaining REIT status. There are almost 800 private REITs in the United States.

There are nearly 200 **publicly traded REITs** registered with the SEC and traded in major stock exchanges such as the New York Stock Exchange, NASDAQ and the American Stock Exchange. Because they're traded on an exchange each day, publicly traded REITs are simple for investors to buy or sell and offer great liquidity. Total assets of these listed REITs exceed $400 billion.

About 20 **non-exchange traded REITs** are registered with the SEC but not traded on any of the public exchanges. Instead, they have private sponsors who market them to investors-often those who have been burned elsewhere in the market and seek relative stability. In exchange for easy liquidity, REIT sponsors focus on the benefit of not having to "time the market." They often promote non-exchange traded companies as providing insulation from fluctuations in the market and, in part, as fixed-income investments that offer better returns than bonds, certificates of deposit, money market funds and similar financial instruments.

TICs

TICs are a way to own commercial real estate without physically managing it while getting a pretty much fixed return on investment. Basically what you're doing is buying piece of the property along with other investors. And it will be managed by the TIC company, the company sponsoring the investment.

Tenancy in common investments ("TIC" or "TIC Investments") have become a booming industry in the United States in recent years. A tenancy in common investment (better known as a TIC) is an investment by the taxpayer in real estate which is co-owned with other investors. Since the taxpayer holds a deed to real estate as a tenant in common, the investment qualifies under the like-kind rules of a 1031 exchange. TIC investments are typically made in projects such as apartment houses, shopping centers, office buildings, etc. TIC sponsors also known as TIC companies arrange

TIC syndications to comply with the limitations specified by the IRS with Rev Proc 2002-22 which, among other things, limits the number of investors to 35.

This type of an investment can appeal to taxpayers who are tired of managing real estate. TICs can provide a secure investment with a predictable rate of return on their investment. Management responsibilities are provided by management professionals. Cash returns on these types of investments are typically in the 6% to 7% range. Syndicators of TICs are called "sponsors." Investment offerings can be made directly by the sponsor or by brokers who can assist taxpayers with an assortment of offerings currently on the market.

TIC investments are treated by most sponsors as securities because they meet the definition of securities either in the state where the property resides or in the various states where the sponsor intends to offer the investment for sale. The SEC has not ruled on this issue but most states are quite clear in their statutes that these investments are securities under state law. This means that only licensed security dealers may market these investments. However, even though the investments may be securities under state law, the investment is a real estate investment for purposes of a 1031 exchange.

Some sponsors of TIC investments structure their TIC so that the investment is a real estate investment not subject to state security laws. Usually this means that the TIC sponsor will not be responsible for management of the investment and independent management will be employed.

TIC investments are commonly structured in one of the following ways –

- A single-tenant property with an established credit rating,
- Multiple tenants subject to a single master lease with the TIC sponsor who subleases to the tenants,
- Multiple tenants each with separate leases managed by professional management.

Taxpayers considering a TIC investment should be prepared for an investment which may last for several years with limited liquidity. As with any other real estate investment, an investment in a TIC can be subject to various business risks. Taxpayers should research track records and management performance of sponsors who are offering TIC investments. They should also carefully review any available proforma operating statements and prospectus.

A list of TIC sponsors and brokers by state can be found on the website of the Tenant In Common Association (TICA) at www.ticassoc.org.

Real Estate Crowd Funding

Title II of the JOBS Act of 2012 included a provision allowing companies to sell securities through open platforms such as the internet and lifted a ban on general solicitation and advertising in specific kinds of private placements of securities. This gave rise to a brand new commercial real estate investing opportunity for accredited investors, called Real Estate Crowd Funding. In a very short period of time, there has been an absolute explosion in the number of companies offering these investments and currently we are in the infancy of this investing opportunity. With real estate crowd funding, you are buying shares of an investment property. Proponents of this new type of commercial real estate investment argue that investors have a much greater understanding of where their investment dollar is going than in REIT because it is specific to one particular property. But the drawbacks would be that you have to be an accredited investor to participate and depending on what the exit strategy of the crowd funding manager is, your funds could remain tied to that investment for a significant period of time. Further, as with any industry in its infancy, proceed with caution since no company has a long term track record.

Chapter 5
Getting started in Commercial Real Estate

Tools you need to get started in commercial investing

• **Desire** is numero uno! A great mentor of mine shared with me that "to achieve anything great and worthy, it's not going to be easy, you gotta have a strong desire in you". A strong desire outdoes talent and gifts any day when it comes to real estate investing.

• A **computer** with internet access – thankfully technology allows us to search and research commercial properties and owners of commercial properties nationally without leaving the comfort of our homes.

• A **cell phone** or telephone with voicemail – you'll have to call real estate agents, sellers, property managers, set up appointments, and perform simple due diligence tasks.

• Simple **calculator** – get one, nothing fancy is required, or you can use online calculators or phone app calculators.

• **Start in your own backyard.** I suggest starting your market research and having an intention on investing in your own city first. It is by far the easiest and most efficient way to begin. Investing out-of-state for the first-timer should be your last resort and should be done with the help and guidance of a skilled-advisor. By starting locally, you'll be able to drive around, meet people in person, check up on the property easily, and learn the business faster.

- Minimum **two-four hours per week** of dedicated time to work on this endeavor. Obviously, the more hours you put into your goals, the quicker they will come to reality.

Tools <u>not required</u> to get started in commercial investing…

- You *don't* need a real estate license to buy commercial real estate.
- You *don't* need to have started in residential real estate investing first to go into commercial real estate.
- You *don't* need to have a business MBA to understand everything in commercial real estate.
- You *don't* need to be a millionaire to do your first deal (although a little bit of money can go a long way).

How to Become a Commercial Real Estate Investor INSIDER

To become a commercial real estate investor insider, it is pertinent that you are up to par, and even an expert in your comfort zone. These things listed here are how you are constantly informed and a step ahead of other real estate people, as well as your own market.

Besides doing these things religiously, and always analyzing the data that you collect, there are a few other specific tools that will allow you to see into your commercial real estate future and identify opportunities that others will miss.

The first is a city's future land use master plan or map that shows the future zoning and use for all the land within a city's limits. Some cities may not have one if they are too small and not looking for growth. However, most cities do have master use plans that are used to dictate the entire future of a city's economic make-up.

This map is used to plan for growth so that all elements of a city are controlled. Zoning and use may change for operating properties; others may remain the same. There is the possibility of raw land to be annexed into the city, having a specific use, offering huge opportunities to the commercial real estate investor. There may be a need to tear down or renovate old properties, and develop them for a different use.

The possibilities of what a future land use map holds is gold in the eyes of an investor, and extremely important to all those working in commercial real estate. Refer to this map, and actually visit the locations of where there is change to identify opportunities. As every area is different, you will be amazed as to what opportunities will unveil themselves when you bring to it a little vision, creativity, and insider information regarding the zoning and use of a property.

Another tool to see into the future is the economic forecast for your area. By looking at both the past and future per capita income, population growth rates, housing costs and other such data that can be found through the census and local Chamber of Commerce, you can see the overall economic environment of your city and how it is performing.

Perhaps a continuing decrease in population means people are moving out of the city, telling you not to invest in new home or apartment development in that area. Or, the growth has been so extreme that the city is in desperate need of commercial property in order to support the influx of people. You can definitely plan on how you are going to move in the market with this information by your side.

The final tool I urge you to utilize when predicting your commercial real estate future is already approved infrastructural changes within your city. This will require you to attend city meetings regarding zoning, planning, development, etc. There could be discussion of a new development a year or more before it actually occurs, and once you hear about it, you can start putting your own ideas into place.

As I am sure you already know, large, influential, infrastructural changes can greatly increase the land values of properties that surround them. For example, a large strip mall being developed will increase the value of all the land surrounding it, as well as possibly call for a greater demand of residential units, and an increase in the lot and rental prices that can be charged according to the new market.

Let's say that you hear two years in advance about a strip mall that will begin development after it is approved. You are then going to get a jump on all competition, look at the site, the land surrounding it, and the opportunities it may offer. Can you purchase the now extremely cheap land adjacent to this site, or perhaps the poor performing apartment complex in anticipation of this new development so that you may benefit from the price increase this major infrastructural change is going to cause?

Absolutely!

These things happen all the time and I urge you to be a visionary and look to the future. After all, this is where a majority of commercial real estate profits is made- by creating something that either wasn't there, or improving upon what is there.

As you can see, you may not have a crystal ball that does all the work for you, but I promise that if you use these tools and follow these guidelines, you will be preparing yourself for great opportunities that others, quite simply, will overlook. It will take some effort and constant dedication. However, the results that you yield will be more than worth it. Actually, it is much easier to be the first mover, rather than suffering the increased land prices and changes after a development is already in place or even underway.

Realize your power to predict the future and plan your goals accordingly! You will be successful with these tools, so implement them today.

Many people may not realize you can literally become a commercial real estate insider just by working in your own local community. There is a wealth of opportunity for those who are motivated and wanting to make a difference, not only in their own lives, but in the lives of people in the community as well.

You do not have to travel across the United States or around the world to find money making properties that will financially take care of you for the rest of your life. It simply takes two things in order to become a real estate insider: knowledge of your community's real estate opportunities and a steady increase in your own education.

What makes a commercial real estate insider?

A commercial real estate insider knows the ins and outs of the real estate market in his or her own area of interest. This interest could be in office complexes, strip malls, large apartment complexes, medical buildings, and various other income producing properties The commercial real estate insider recognizes trends, the value of property, changes in values before they happen, all zoning laws and regulations, and infrastructural changes that can drastically affect the values of land on or around the new development.

The commercial real estate insider also knows the city decision makers. He or she knows with whom to speak with in order to get information, advice, notice regarding changes in the zoning laws or regulations, and to stay ahead of the real estate market.

How do you become a commercial real estate insider?

To start, you should understand that a large part of commercial real estate is dealing with the officials and decision makers of the city or county because they are the ones who decide zoning and use for every piece of property within the city's or county's boundaries. They plan for future growth, and attempt to create a balance among both residential and commercial properties so that the community does not grow too quickly or become unbalanced.

Due to the fact that the city officials are so important to your ability to develop, renovate, and otherwise do what you want to a property, it is crucial that you get to know these people and create a rapport. You also need to know what is occurring in your community regarding real estate at all times. Zoning often changes, there may be new regulations or codes regarding the zoning, or the intended use could be limited to only a few uses that will hinder your intended project. All these things can greatly affect your dealings with a specific property and how you pick and choose your opportunities.

A good way to meet these important officials, as well as learn about the real estate market in your community, is to attend zoning and planning meetings at your local Chamber of Commerce or courthouse. It is there that you can meet face to face the people who will influence your future as a commercial real estate insider. Introduce yourself as a real estate investor, and give them your card. Ask intelligent questions regarding real estate in your community.

Eventually, after building a rapport with these influential people, ask if you could meet with them to discuss a certain project, or something in which you could use more information or advice. You should always come to these meetings prepared with your questions so you stay on task and topic. Show that you appreciate their time, knowledge and expertise.

It is a great idea to ask for a few more introductions to people they know who may be able to help you. Always send a thank-you note that briefly reviews your discussion, what advice you used and how it will or has helped you. When you show appreciation for their advice, they are more likely to help you in the future, or share information of which others may not be privy. You will begin to make excellent contacts and learn key elements regarding your specific market. This is how you become a commercial real estate insider.

Beyond meeting the people who make the big decisions regarding the use of property in your community, you must know the laws and regulations regarding the various types of zoning. Zoning labels may differ from city to city, as do building criteria, the size of lots, building and fire codes, and limitations. You must study these rules and regulations so you know what you can and cannot do to a property. As these rules and regulations often change, it is important that you listen and take solid notes at all zoning and planning meetings, and other important real estate related meetings you might attend.

Your goal is to know your market inside and out so you can make decisions based on the changes in the market before anyone else even knows they are coming. You do this by recognizing certain points, such as an increase in vacancies of commercial property, or an increase in the median home price, or how the new mall planned to be developed in one year is going to greatly affect the land values around it.

In addition to understanding your own market, you should be reading the newspaper, trade journals, commercial real estate books, attending seminars, and speaking with others in your area who are involved with real estate so that you are constantly increasing your knowledge. It is with this constant training that you will learn strategy, finance, information about private lending, how to find deals, how to present offers, what markets are hot, new opportunities in the area others are not aware of, and many other tools and strategies that will keep you ahead of the rest.

To be a real estate insider, you must always be on your game. Make those contacts. Ask pertinent questions. Learn everything you can about your business, and act on this information. You will discover that you find opportunities that you did not know existed, and you will become a commercial real estate investor insider sooner than you would think!

Chapter 6
A Simple Way to Analyze Commercial Real Estate

To get straight to the point, once you find a commercial deal to evaluate, you'll need to find the answer to this all-important question rather quickly:

How much is the cash flow?

In evaluating any commercial deal (or any income-producing property), there are **3 Steps to figure out Cash Flow**:

3 Steps to Cash Flow

- **Step 1: G**et the income per year
- **Step 2: G**et the expenses per year
- **Step 3: G**et the debt service per year

This is all you need to *initially* evaluate *any* commercial deal!!!

After you do this, all that's left is simple subtraction:

Step 1 amount

minus Step 2 amount
minus Step 3 amount

= Cash flow per year

Step 1 is to find out what the total rents are per month. Add it all up and then get the yearly amount by multiplying by 12.

Step 2 is to find out what the operating expenses are on a monthly basis. The operating expenses do not include mortgage principal or interest, but do include typical items such as taxes, insurance, utilities, repairs and maintenance, property management fee, salaries, landscaping, administrative costs, advertising, and supplies.

Step 3 is to find out what the monthly mortgage would be if you bought the property and then multiply that amount by 12 to get an annual mortgage amount.

Let's do a quick 'n easy deal evaluation: 8 unit apartment building

8-plex	Asking price: $250,000
Two 2-beds/1-bath units	Rents: $600 per unit, all occupied
Tenants pay own utilities	Owner pays for gardener: $50/mo.
Taxes: $2,500/yr	20% down payment @ 7% int. for 30yrs.
Insurance: $1500/yr	Property mgr: $6,000/yr
Repairs/Maint.: $2800/yr	Marketing: $1,000/yr
Utilities (common): $1600/yr	Supplies: $1,000/yr

Step 1:

The income is $600 per month per unit x 8 units = $4,800 per month total x 12 months = $57,600 per year. Therefore, income is $57,600 total per year.

Step 2:

The expenses total up to = $17,000 total per year.

Step 3:

The debt service is:

1. Figure out the principle: $250,000 – 20% down payment: $250000 - $50,000 = $200,000
2. Figure out the monthly payment on the principle at a 7% interest rate with 30-year amortization. Using an online mortgage calculator, the payments come out to be $1331 per month.
3. The debt service is $1331 x 12 months = $15,972 per year.

Now, you have all three things you need to calculate the cash flow.

Therefore the cash flow is:

Step 1 amount ⇨ $57,600 per year
- Step 2 amount ⇨ $17,000 per year
- Step 3 amount ⇨ $15,972 per year
= Cash flow per year ⇨ $24,628 per year!

Was that too difficult?

What you just did can be used for any type of income-producing real estate – office, shopping center, self-storage, mobile home park, etc.

How to get mastery of property evaluation

What does it take to have mastery in anything? First of all, mastery is earned, not born with. Masters deliberately practice their field and concentrate their efforts on improving their skills. And, if you'd like to have mastery in evaluating commercial deals, you'll need to do three specific things: (1) Know and understand fundamental investment terminology; (2)Put it to use on a regular basis; and (3) Practice even more.

Want to build instant rapport and credibility with brokers and property owners? Then start using some of the terms you learned here in your conversations with real estate agents, brokers, and owners. When I was new to investing, I noticed that when I used words such as *operating expenses, expenses per unit, cap rate, and debt service*, they paid more attention to me. It seemed that using those words "bought" me inside their world. They no longer saw me as a newbie wasting their time. It gave me instant credibility even though I hadn't purchased one property yet. Try it and you'll see what a difference it makes.

The following are 10 most basic and key commercial real estate investment terms that are a must to become familiar with. These 10 are the bare minimum you must know to become successful.

Key Investment Terms to Master

Gross Income ($)

Rents, laundry, or vending machine income (could be monthly or annual).

Vacancy ($)

A unit that is left unoccupied and is not producing income is a vacancy. A unit that is vacated and re-rented in the same month is not considered a vacancy. It is considered a turnover.

Vacancy Rate (%)

The number of vacancies divided by the number of units

$$\frac{\text{total vacant units}}{\text{\# of total units}}$$

Effective Gross Income ($)

Gross Income - Vacancy

Income – (Vacancy Rate (%) x Income) = Effective Gross Income

Operating Expenses ($)

Annual operating expenses of the property typically include taxes, insurance, utilities, management fees, landscaping, maintenance, repairs, and advertising. This does not include mortgage payments or interest expense.

<u>Net Operating Income (NOI) ($)</u>

Effective Gross Income minus Operating Expenses

Effective Gross Income - Operating Expenses = NOI

<u>Debt Service ($)</u>

Monthly Mortgage Amount multiplied by 12 Months

Monthly Mortgage Amount x 12 = Debt Service

<u>Cash Flow ($)</u>

Net Operating Income minus Debt Service

NOI – Debt Service = Annual Cash Flow

If you then divide this number by 12, you end up with the *monthly* cash flow

<u>Cash-on-Cash Return (%)</u>

Annual Cash Flow divided by Down Payment Amount

Annual Cash Flow

Down Payment

<u>Capitalization Rate (%)</u>

Net Operating Income divided by the Sales Price. Also known as the "cap rate", it is the measure of profitability of an investment. Cap Rates tell you how much you will make on an investment if you paid all cash for it, therefore financing and taxation are not included.

$$\frac{\text{NOI}}{\text{Sales Price}}$$

The next step is to understand how these terms are used in every day deals. We'll do that by using all of them in example or practice deals. There's no need to memorize the terms at this point, but what you'll discover is that these 10 terms will start to sink in your head as you go though more and more examples and practice deals. Guaranteed.

Chapter 7
4 Guiding Principles of Commercial Investing

Establishing your 4 Guiding Principles of Investment

What types of commercial property should I consider making offers on and buying? That's a very good question. On what basis do I make my buying decisions? What is a good cash flow? What is an acceptable return on investment? What is a decent cap rate? How and when do I use gross rent multiplier? These are all good questions that you or anyone contemplating investing in real estate should be asking.

First of all, you'll need a working knowledge of the following: cash flow, cash-on-cash return, cap rate, and gross rent multiplier. You'll need to know the definition and know how to calculate them.

Secondly, you'll need to know how cash flow, cash-on-cash return, cap rate, and gross rent multiplier affect your investment. We'll learn this in a second.

I am assuming that, by now, you can define and calculate cash flow, cash-on-cash return, cap rate, and gross rent multiplier. So, what is left to learn is how each of these investment terms affects your investments and decision-making. The following investment terms are now your Guiding Principles of Investment Terms.

1. **Cash Flow**
2. **Cash-On-Cash Return**

3. **Cap Rate**

4. **Gross Rent Multiplier**

Cash flow: Positive cash flow will be the main goal and it will be one of our primary objectives. Positive cash flow creates and maintains your investments' momentum. What puts you in a good mood – positive cash flow or negative cash flow? When purchasing commercial property, a bank's basis for lending is the building's cash flow abilities and property condition. A building with poor cash flow will almost always appraise much lower than its comparables for the area.

1st GUIDING PRINCIPLE: <u>POSITIVE</u> CASH FLOW

Cash-on-Cash Return %: This is the velocity of your money. In other words, how long does it take for your money (down payment) to come back to you? If your down payment was $20,000, how soon does your cash flow add up to $20,000? If your cash flow added up to $20,000 in <u>one year</u>, then your cash-on-cash return is 100%. If it takes <u>two years</u>, then your cash-on-cash is 50%. If it takes <u>three years</u>, then it is 33% and so on. Real estate can potentially produce phenomenal returns. Cash-on-cash returns of over 100% are not uncommon. Now, if you were to go to your local bank and deposit $20,000 into their most aggressive CD investment for one to three years, what type of cash-on-cash return can you expect? 2%? 4%?

We need to put an emphasis on cash-on-cash return when we invest simply because you need to know how fast you can get your down payment back so you can invest it again...and again.

2nd GUIDING PRINCIPLE:

<u>DOUBLE DIGIT</u> Cash-On-Cash Return%,

<u>10% OR GREATER</u>

Capitalization Rate %: A cap rate is used as a measure of a building's performance without considering the mortgage financing. If you paid all cash for the investment, how much money does it make? What's the return? Cap rate is a standard used industry-wide. It's used in many different ways. Here are a few ways to consider:

A **high cap rate** usually typifies a **higher risk investment** and a **low sales price.** High cap rate investments are typically found in poor, low income regions. A **low cap rate** usually typifies a **lower risk investment** and a **high sales price.** Low cap rates are typically found in middle class to upper income regions. Therefore, neighborhoods within cities have "stamped" on them their assigned cap rates.

With that said, if you know what the NOI is, and you know the given cap rate, then you can calculate what the sales price should be. Sales Price = NOI/Cap rate.

3rd GUIDING PRINCIPLE:

CAP RATE OF <u>8% OR HIGHER</u>

Gross Rent Multiplier: Gross rent multipliers are used as a measure to compare income properties in one area or neighborhood. Let's say there are three rented apartment complexes in a neighborhood.

One of them goes up for sale. If you know the gross rent multiplier for the neighborhood, then you can gauge if it is comparable to the other two complexes.

If the gross rent multiplier of one of the complexes being sold is higher than the other two, then you may be paying too much. If the gross rent multiplier of the complex being sold is lower than the other two, then you may be getting a property under market price.

Gross rent multiplier is also a good indicator of the investments' ability to cash flow. As the gross rent multiplier lowers, your cash flow increases in most cases. And the opposite is true. As the gross rent multiplier increases, your cash flow typically decreases.

4th GUIDING PRINCIPLE:

GROSS RENT MULTIPLIER OF <u>9 OR LOWER</u>

(***Important Note:*** When you are looking at income properties and analyzing them, it is absolutely necessary to have your four <u>Guiding Principles of Investment</u>.)

Listed above, we have established your *starting* guiding principles. Without them, you will wander aimlessly in the real estate investment game. No working goals = a very weak game.

Your established guiding principles of investment are your standards. If an income property does not match up to your guiding principles, then the property must be passed on. Go on to the next property in search of one that matches. The one exception you'll make occurs when you are analyzing a value-add opportunity.

In summary, HERE ARE YOUR GUIDING PRINCIPLES OF INVESTMENT

1st Guiding Principle of Investment – **POSITIVE CASH FLOW**

2nd Guiding Principle of Investment – **DOUBLE DIGIT Cash-On-Cash**

Return%, 10% OR GREATER

3rd Guiding Principle of Investment – **CAP RATE OF 8% OR HIGHER**

4th Guiding Principle of Investment – **Gross Rent Multiplier OF 9 OR LOWER**

Chapter 8
3 Commercial Analysis Examples

Mastery of real estate investment terms through property analysis

The purpose of these exercises is to measure your readiness in understanding how property is analyzed by using the investment terms and mastering them. As each property is analyzed, each investment term will take on a more definite meaning. The terms will begin to sink in and things will start to “click”.

There are 3 practice properties. Remember, it’s practice. It’s okay to not know. It’s *not okay* to pretend you know. Take as much time you need in completing both exercises. By the end of the exercise, our goal is to enable you to fundamentally analyze just about any commercial investment by knowing how to calculate **cash flow, cash-on-cash return, and cap rate.**

We will review each practice property in full detail. Each of these properties has their own unique problem or twist. Solving problems and spotting twists are keys in spotting poor, average, or great investments. You will learn this.

Example #1: A 20 unit apartment bldg

Address: 1220 Sixth Ave, Quantumberry, CA **Orchard Spree Village Apartments**

Description: 20 -2bdrm **Type:** Multi-Family **Yr blt**: 1972 **Sq. Ftg:** 22,160sf
Asking Price: $550,000 ($27,500/unit) **Down payment:** 20%, $110,000 **DOM:** 39
Mortgage: $440,000 @6.5% - 30yr amt., $2,781/mo 10yr term **Class:** C

Details: Well-maintained 20 unit complex located in up and coming area one block from City Hall. Owner just spent over $100,000 in rehab and upgrades last 12 months, all new furnaces and A/Cs. Owner is retiring to Florida with family. Professional property management in place and managed very well. Apt mgr gets free rent for services. Good rental history. Covered parking. Tenants pay electric and heat. Owner pays water and garbage. Storage galore. Solid investment.

Income: 2bdrm: $525/mo Avg. (20 units)		Total: $126,000/yr
Vacancy rate: 10%		<$12,600>
	Effective Gross Income	**$113,400**

Expenses:	Insurance	$4,500/yr
	Real Estate Taxes	$9,610
	Maintenance	$14,900
	Electrical (common area)	$1,300
	Water/Sewer	$9,400
	Property Mgmt (5%)	$6,210
	Garbage	$1,150
	Supplies	$2,700
	Reserves	$6,000
	Accounting	$1,400
	Total Operating Expenses	**$57,170**
	Expense%	**50%**
	Expense per unit	**$2,858**

Building Performance:	**Net Operating Income:**	**$56,230 /yr**	
	Debt Service:	**$33,372/yr**	
	Cashflow:	**$22,858 /yr**	**$1905 /mo**
	Cash-on-Cash Return:	**21%**	
	CAP rate:	**10%**	

How to Look at Example #1

<u>Here's what I see right away:</u>

2. Appears to be well-maintained and a stabilized investment on paper.

3. A lot of upgrades have been done so repair costs should be in-check.

4. Cash flows well and conservatively.

5. Solid class C property.

<u>Here's what to pay attention to:</u>

1. 5 units or more is considered "commercial" and requires at least 20% down payment or more.

2. Expenses are 50% of Effective Gross Income. That's rather high for a 20-unit apartment building. Should be in the 40% range.

3. Pay attention to the price per unit (sales price/no. of units) figure. It's an important indicator that all apartment experts use to gauge how much they are paying for in terms of value. Apartment experts talk "price per unit" rather than overall sales price. It will help you determine if you are paying too high of a price or if you are buying under market.

4. Who pays for what utilities? On this property, having the tenants pay for their own electricity and heat with the owner paying for water and garbage is ideal and typical. Beware of properties that are "master-metered" for electricity and heat. That

means that there is one utility meter for the entire building and the owner pays the whole bill. Not good.

5. Don't miss out that the live-in apartment manager gets free rent. Did you run your analysis on 20 units or 19 units rented? Do you plan on keeping him or just using a property management company and rent out his unit?

6. There is plenty of storage on the premises. Could this be a possible means of additional income?

Example #2: ***Delaney Plaza***

Address: 253 Delaney Blvd, Anytown, NY **Delaney Plaza Shopping Center**

Description: 36,000 SqFt Strip Mall **Type:** Retail Strip Ctr **Yr blt**: 2005 **Sq. Ftg:** 36,000sf
Asking Price: $3,100,000 ($86/SF) **Down payment:** 20%, $620,000
Mortgage: $2,480,000 @6.5% - 30yr amt., $15,675/mo 7yr term **Class:** B

Details: a 36,000-square-foot retail center, 3 acre lot, anchored by a major chain sporting goods store, center of town, right in the path of progress. The retail center is composed of eight stores of various types, ranging from a coffee shop to a regional bank. All leases are triple net (NNN), with the owner charging the tenants for common area maintenance (CAM). The CAM expense for the owner is $3,000 per month and includes landscaping, parking lot, hallways, and restrooms.

Income Table and Square Footage for Delaney's Plaza

Tenant	*Square Footage*	*Rent Per Square Foot*	*Yearly Rent*
Sporting goods	10,000	$10	$100,000
Bank	8,000	$8	$64,000
Coffee shop	1,500	$5	$7,500
Camera supply	1,500	$5	$7,500
Shoe store	1,000	$6	$6,000
Deli shop	2,000	$6	$12,000
Women's clothing	6,000	$7	$42,000
Office supply	6,000	$8	$48,000
Total	**36,000**	—	**$287,000**

Expenses: For the expense breakdown, because all are triple net leases, the tenants pay all property operating expenses. The landlord takes care of all common area maintenance expenses, but bills all of them back to the tenants, divided among them. Therefore, hard operating expenses are zero for the landlord.

Building Performance:	**Net Operating Income:**	**$287,000 /yr**	
	Debt Service:	**$188,100 /yr**	
	Cashflow:	**$98,900 /yr**	**$8242 /mo**
	Cash-on-Cash Return:	**16%**	
	CAP rate:	**9.3%**	

1. Does this deal meet the guiding principles?

2. Is this a deal you'd be interested in pursuing? If so, what qualities do you like?

3. What would you offer? Full price? Or how much lower?

<u>A few points of discussion here:</u>

1. This seems to be a pretty solid deal.

2. I would research the leases and make sure all of them don't expire soon. If they do, I'd attempt to re-negotiate a lease extension to ensure my income for at least 5 years.

3. I'd look for ways to profit from acreage that's not being utilized. Perhaps add a pad site or two.

4. The mix of tenants is excellent.

5. The comment above, "right in the path of progress" concerns me. Does this mean that the neighborhood could get worse if revitalization does not continue? In retail, there's a saying – "you can fix a property, but you can't fix a location". Therefore, in retail, location is of the utmost importance.

Types of leases and the lease agreement: Retail's number one priority

I once had a large mall owner share with me, "when you buy a shopping center, what you buy and invest in are the leases, and building comes for free". Of course that's not exactly true, but what that statement does do is illustrate how important leases are to the value of the investment. A *lease* is a written legal agreement between the landlord and the tenant that establishes how much the tenant will pay in rent; how long the tenant is legally committed to stay;

any additional payments by the tenant for taxes, insurance, or maintenance; rent increases; renewal clauses and options; and all rights, privileges, and responsibilities of the tenant and landlord.

Even though retail leases are long term — say, 5 to 15 years in length — it's common for leases to have rental increases or "bumps" as we call them during the leasing years. You could have a rent escalation of 5 percent once every five years until the lease expires, for instance.

Here are three types of leases you'll most likely come across in retail investments. Each has its small differences, so pay close attention:

- **Gross lease:** the landlord agrees to pay all operating expenses and charges the tenant a rent that's over and above and covers the operating expenses. The types of expenses covered include taxes, insurance, management, maintenance, and any other costs associated with operating the property.
- **Modified gross lease:** this lease is slightly different from the standard gross lease in that some of the operating expenses — such as maintenance, insurance, or utilities — aren't paid for by the landlord and are passed on to the tenant. These expenses are called pass-through expenses because they're passed through to the tenant. Many office-type buildings use a modified gross lease.
- **Net lease:** in a net lease, the tenants pay the operating expenses of the property and the landlord gets to net a certain amount every month by charging rent over and above the total operating expenses. This lease is favorable in many ways: It's favorable to the landlord because she isn't responsible for any operational

expenses of the property. It's favorable to the tenant because he gets to fix up his store as he sees fit and do his own maintenance and cleaning. Net leases are typically customized to fit tenant needs.

This type of lease is used mainly by retailers. The landlord takes care of the common area maintenance, and the expense of that is spread among the tenants and billed back to them.

There are four different levels and types of net leases:

- **Single net lease (N):** In a single net lease, the tenant agrees to pay property taxes. The landlord pays for all other expenses in the operation.
- **Double net lease (NN):** In a double net lease, the tenant agrees to pay property taxes and insurance. The landlord pays for all other expenses in the operation.
- **Triple net lease (NNN):** This type of lease is most favorable for landlords and is one of the most popular today. The tenants agree to pay the landlord rent plus all other property-related expenses including taxes, insurance, and maintenance. The landlord gets a true net payment. Banks, fast-food restaurants, and anchor tenants typically use triple net leases.

A great income generator for landlords is to have a clause called *percentage of sales* built in the lease. Here, the landlord gets an additional payment from the tenant if and when the tenant reaches a certain sales volume or profitability. For example, say a coffee shop has agreed to pay an additional 4 percent of its gross sales after its sales reach a certain level. The landlord would be paid the 4 percent in addition to its normal lease payment.

Treat leases and every piece of language in it like treasure!

Understanding Commercial Leases

Your lease is a contract between you and your landlord. A lease can be for a short term (as little as one month) or long term (up to 15 years!), and it can be written or oral -- although a lease for more than a year must be in writing to be legally enforceable. Some people use the phrase "rental agreement" to describe a short or oral lease for which rent is typically paid once a month and the tenancy can be terminated on a 30-day written notice. To avoid confusion, we'll stick to the word "lease."

Terminology

> Sometimes a written lease talks about the "Lessor" and the "Lessee." The lessor is the landlord; the lessee is the tenant.

It's crucial to understand from the get-go that, practically and legally speaking, there are oceans of differences between commercial leases and residential leases. Commercial leases are not subject to most consumer protection laws that govern residential leases -- for example, there are no caps on deposits or rules protecting a tenant's privacy. Also, since a business will often need to modify the existing space (add cubicles, raise a loading dock, rewire, etc.), the terms of commercial leases are usually subject to at least some negotiation.

The following checklist includes many items that are often addressed in commercial leases.

• Rent, including allowable increases and method of computation

• Security deposit and conditions for return

• Length of lease (also called the lease term)

• Whether the rent you pay covers utilities, taxes, and maintenance (called a gross lease) or whether you will be charged for these items separately (called a net or, if the tenant must cover three additional costs, a triple net lease)

• Whether there's an option to renew the lease

• If and how the lease may be terminated, including notice requirements

• What space is being rented, including common areas such as hallways, rest rooms, and elevators

• Specifications for signs, including where they may be placed

• Whether there will be improvements, modifications, or fixtures (often called buildouts) added to the space, who will pay for them, and who will own them after the lease ends

• Who will maintain the premises

• Whether the lease may be assigned or sublet to another party

• Whether disputes must be mediated or arbitrated as an alternative to court

• A lease should address what improvements or modifications can be made to the property, which party will pay for the improvements, and whether the tenant is responsible for returning the unit to its original condition at the end of the tenancy.

• Many lease agreements will incorporate a use clause to define the activity the tenant can engage in on the premises. These clauses are in place to protect the property from damage and limit the liability of the property owner. If possible, ask for a broad usage clause just in case the business expands into other activities.

• Exclusivity clause is an important clause for retail businesses renting space in a commercial complex. An exclusivity clause will prevent a landlord from renting space to a competitor.

• Ask the landlord for the right to assign the lease or sublet the space to another tenant. This is an important term because the tenant is still responsible for paying the rent if the business fails or relocates, but with a assignment or sublet clause in place, the business can find someone else to cover the rent.

• Compliance with the Americans with Disabilities Act: Under the act, if a business is open to the public and has more than 15 employees, the premises must be accessible to people with disabilities. The lease should determine who is responsible for making any necessary alterations to the property and who must pay for these changes.

The Due Diligence chapter includes more about leases and what to look for.

Example #3: 80 unit Apartment Bldg

Address: 333 Faith Blvd, Okeydokey, NY **Hawaiian Terrace Apts**

Description: 30 -1bdrm 34 -2bdrm 16 -3bdrm **Type:** Multi-Family **Yr blt**: 1972 **Sq. Ftg:** 52,370sf
Asking Price: $2,060,000 ($25,700/unit) **Down payment:** 20%, $412,000 **DOM:** 91
Mortgage: $1,648,000 @6.5% - 30yr amt., $10,416/mo 3yr term **Class:** C

Details: 80 unit complex, 5 buildings. Huge acreage. Great area. Absentee owner, mismanagement, and lack of capital make this a perfect project for rehabbers. 25% vacancy at present. Partnership splitting up. Good mix of 1,2,3s. Owner motivated. Needs TLC. No financials released until offer is made.

Income: 1bdrm: $395 Avg. 2bdrm: $500/mo Avg. 3bdrm: 575 Avg. Total: **$456,600 /yr**
Vacancy rate: 25% **<$114,150>**
Effective Gross Income **$342,450**

Expenses:	Insurance	$18,500/yr
	Real Estate Taxes	$20,610
	Maintenance	$24,900
	Landscaping	$4,800
	HVAC Service	$6,400
	Electrical (common area)	$7,300
	Water/Sewer	$29,400
	Property Mgmt (5%)	$17,122
	Salary	$24,000
	Garbage	$4,150
	Supplies	$18,600
	Reserves	$8,000
	Accounting	$3,600
	Total Operating Expenses	**$187,382**
	Expense%	**55%**
	Expense per unit	**$2,342**

Building Performance:	**Net Operating Income:**	**$155,068 /yr**	
	Debt Service:	**$124,992 /yr**	
	Cashflow:	**$30,076 /yr**	**$2506 /mo**
	Cash-on-Cash Return:7%		
	CAP rate:	**8%**	

1. Are the Guiding Principles met? If not, what areas could you address to meet them?
2. What areas could you improve to increase the cash flow?
3. What price would you offer?
4. Does this deal excite you? If so, why? If not, why?

How to Look at Example #3

<u>Here's what I see right away:</u>

1. This is a distressed property in many ways.
2. Why is it 25% vacant and what caused it?
3. There is lots of room for improvement.
4. The unit mix is good.
5. Need to find out how motivated the owners are.
6. There is a lot of upside potential in income on this deal, but it's going to take a lot of work to realize it.

<u>Here's what needs to be addressed:</u>

1. Deferred maintenance.
2. The 25% vacancy. It is 75% physically occupied. I wonder out of that 75%, how many are actually paying tenants that are not delinquent. In other words, I wonder what the "economic" occupancy is.
3. What the partnership issues are. This may put roadblocks to getting the deal done and waste much of your time.
4. What's the cost going to be to fix up the property and how long will it take?
5. Need to find out the following: once the property is fixed up and stabilized: What would it be worth then? And what would the cash flow be if you could bring the vacancy down to 7%?

6. Your other concern should be getting a new loan for this property. Is it possible to get a decent loan in the current lending environment? Also, is the current loan assumable? If so, what is the balance and terms? You should explore creative financing strategies such as a "master lease" or "land contract". That way, no banks are involved.

<u>How much money over time could I make with this property?</u>

1. To figure this out, let's fast-forward and also make a few assumptions.

   a. You were able to get the vacancy down to 8%.

   b. You were able to raise the rents by $25 per unit after the rehab.

   c. You brought the expense percentage down 5% to stabilize at 50%.

   d. We'll use the loan terms given above.

2. Therefore, the income would increase in the following way. The 1-bed rents would go up to $420/mo. The 2-bed rents would go up to $525/mo. And the 3-bed rents would go up to $600/mo. That gives you a yearly gross income of $480,600.

   Now, subtract 8% vacancy and you get an effective gross income of $442,152.

   Next, we decided that the expenses would be 50% of the effective gross income and that comes out to be $221,076. Therefore the net operating income (NOI) is $221,076. That's an increase of $66,008 from when you first started.

Now, divide the NOI by an 8cap to get the new value. Here's the math: $221,076 / .08 = $2,763,450. If you paid the asking price of $2,060,000, you would have made over $700,000 in profits. That's not too bad for fixing up a few apartments over time. This example shows the power of the NOI!

In addition to the new higher value, the cash flow is now $221,076 – 124,992 = $96,084 per year which is an increase of over $66,000 per year from when you first started. This deal is a keeper!

A Parting Word from the Author…

I have saved this last part to share with you some additional reasons why you should invest in commercial real estate.

In my humble opinion, here are five compelling reasons to get started:

Reason #1: ***It's the Most Flexible Way Out of the Rat Race.***

Investing in commercial real estate is the greatest method to build cash flow to supplement your income and to build true wealth over time. The cash flows that are generated are considered "passive" income, while other income (from your job or stock investments) is considered "earned" income which is highly taxed. I personally don't believe in wide diversification of investments as it indicates investors don't understand what they are doing. Invest only in something you have understanding in…focus, focus, focus. You can actually diversify your real estate investing by investing in different types of apartment properties such as small apartments, large communities, A-class apartments, C-class apartments, TICs – and the list goes on.

Reason #2: ***It's Not About You.***

It really isn't all about you. It's about your loved ones, your kids, your spouse, and your family members. It's about charities, ministries, and organizations you always wanted to help, but you didn't have enough resources to do what you really want to do. It's about being abundantly wealthy *(defined as having more than enough)* so that you can turn around and be a blessing to others.

Reason #3: ***It Gets You Closer and Closer to Your Big "WHY".***

What's your "why"? Why are you here on earth? What gifts and talents have been put into you, but you have not used to the fullest? Or at all, perhaps. What drives you? What is your purpose?

A good friend of mine, Ryan, who grew up very poor, went to a birthday party of a well-to-do family. In the backyard, they decided to play a game of "find the money hidden in the bushes". All the kids ran into the bushes and many yelled out that they found money, lots of it. Ryan couldn't find any, but kept digging and jumping in the bushes. In short order, he became a dirty, sweaty mess. It soon became really quiet. Not only did Ryan find no money, but as soon as he looked up, everyone was laughing at him. It was a joke planned against the "poor" kid. There was no money hidden anywhere. As Ryan walked home in complete disgust, he told himself that he would never, ever, be put in a situation like that, or allow his family to be ridiculed ever like that again.

Today, Ryan is a millionaire business person many times over and helps thousands of people with building their business as well. Ryan found his passion and purpose in his adversity. What's your passion or purpose, and what are you doing about it?

Reason #4: ***Let's Prove the World Wrong.***

Are you an over-worked professional? You can't see yourself out of the rat race with your current job? Are you a minority, too old, too young, have plenty of past failures, fearful, a woman, divorced, a single parent, no money? If any of this is you, welcome to the club!

Humans are designed by God to be overcomers by nature. It's never too late to start investing wisely. Just because you have failed at several businesses *(like yours truly!)* doesn't define your future. Your actions today will do that for you. Begin to take action now because the past is behind you, the future is not guaranteed to us, and all we have is today. Do something today. Be intentional about what it is you truly want – today. Let's prove the world wrong. Let's do it together.

Reason #5: *It's a New Season for You.*

Life happens in seasons, have you noticed? You have this book in your hands for a reason. Could it be time to begin a new season in your life? A season of doing something you always wanted to do, but didn't because of the fear of rejection or fear of failure. This could very well be the season to confront those lies you believed for far too long and dare to be what you were called to do and be. *This is your season!*

About Peter Harris

Peter Harris began investing in real estate in the 1990s. He has since purchased over 1000 residential units, large apartment complexes, and various commercial property totaling over $20 million. These acquisitions have spanned the United States, from California to Arizona, New York, Ohio, Texas and Oklahoma. His experience includes, but is not limited to, correcting property management issues, rehabbing commercial buildings, buying commercial REOs, and re-positioning commercial investment properties.

Peter has also worked for Sperry Van Ness Commercial Real Estate and Coldwell Banker previously, focusing on buying and selling commercial real estate and residential income property in the San Francisco Bay Area.

Peter began coaching and mentoring budding commercial real estate investors in in 2003 and to date has coached hundreds of individuals nationwide to begin their own investing. In 2005, he co-authored, with Donald Trump, "Three Master Secrets of Real Estate Success".

He is also the co-author of **"Commercial Real Estate Investing for Dummies"** which was released in the fall of 2007 nationwide.

Besides real estate, Peter's passions include, hanging out with his son, tutoring elementary children, coaching married couples on financial literacy at the church, and cycling.

Peter holds a BS Degree in Applied Physics from Cal-State University Northridge. He also holds a California Real Estate Broker's License.

Currently, Peter is Director of Education for Commercial Property Advisors, a commercial real estate coaching, consulting, and advisory firm specializing in commercial investments in the United States. To learn more about how you could be mentored by Peter and his team in your commercial real estate endeavors, go to www.commercialpropertyadvisors.com