Inside Commercial Real Estate

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In This Issue

Modernize An Older Building

When you want an increased return on an older property it may be time to modernize the property. When you look around a community, you will usually find a number of properties that need to be upgraded. Some existing owners do not recognize the increased return that they could get or do not want to make the necessary investment. Often these buildings can be acquired at a price that reflects the return based on the current condition and income.

When you set out to modernize an older building, you will encounter three kinds of deterioration or obsolescence: The first of these, physical deterioration, starts immediately after the building is completed and continues throughout its entire life, unless it is handled along the way with proper maintenance and repair. This type of deterioration usually can be taken care of by routine repairs and replacement of parts. Anytime the acquisition of a run-down building is being considered, the investor must be certain that the deterioration has not become so bad that the building will have to be demolished.

Functional obsolescence happens when the property loses its usefulness as a result of changes in styles or in the needs of tenants. As an example, an older apartment property could have an electrical system that is inadequate to handle modern appliances such as air conditioning, microwave ovens, computers, television or other recently developed equipment. This type of obsolescence can be cured usually by installing updated equipment.

Economic obsolescence is a change in value that is caused by circumstances that are not directly related to the property. Often this is a change in the neighborhood, such as a change in the use from residential to commercial or industrial. When this has happened, modernization of the building may not be worthwhile. If the building is structurally sound, it could be a good prospect for conversion.

When a building is quite old, structural changes may be needed for safety reasons. Before you purchase the building, a professional engineer should make an inspection. This can determine whether the building is structurally sound and what changes, if any, will have to be made.

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The building can be partially redesigned with architectural changes during the modernization. If a building has very distinctive architectural features rather than a plain exterior, some investors feel that the property has a greater investment potential.

Functional changes and mechanical replacements can reduce costs in an old building and increase efficiency. Wiring will usually need to be replaced to provide safety for modern electrical and computer equipment. Old heating systems will usually be inefficient and cause high maintenance costs, and should be replaced. An example of a mechanical replacement would be a change from an old slow electric elevator to a new high-speed model (often done by simply changing motor and electronic controls).

Aesthetic improvements are the sprucing up of the property and can usually be done at a relatively little cost. When an investor is looking for a quick resale, this type of improvement may be done rather than some of the others. Cleaning up the property, inside and outside, installing new lighting and repainting the building can be enough sometimes to make a quick, small profit.

Modernize For Profit

When an investor is looking for the proper investment, older apartment buildings in good neighborhoods often look better for a long-term commitment than new construction. When a property is modernized, rents can be raised substantially and, if the work can be done without disturbing the existing tenants, the investor will not have the expense of carrying the property as he would in new construction. The investor would also hope that most of the existing tenants would stay and pay the increased rents, so the costs related to acquiring new tenants, as would be needed with a new construction, would be avoided.

Finally, the overall costs may be less. Although the price of the property may be high in relation to the current rents, the final cost after modernization may be far less than the cost of new construction. With this lower cost, the investor may be able to charge lower rents than new buildings nearby, putting him into a very competitive position.

Converting To New Use

Unproductive properties can present opportunities for big profits. When a building is bringing in little or no income because obsolescence or because of changes in the neighborhood that have made the location unsuitable for the original use of the building, converting to a new use can make a new profitable income stream. As an example, a movie theatre in an area converted to industrial might be changed to a factory or warehouse. Some neighborhoods have changed from warehousing and factory areas to residential. A factory building that is no longer being used could be converted to a residential condominium project, a small shopping complex, or an office building.

Don't overlook properties that are still productive, but may have a much greater potential after a conversion. A chocolate factory was converted to a shopping center on the west coast. Movie theatres have been converted to supermarkets. Garages have been converted to condominium parking buildings. Seeing potential profits in older buildings takes imagination.

Give our office a call if you see a building that has potential for another use. ❏

Communication Between Management And Owner

For success in achieving the owner's objectives, there must be open communication between the owner and the management company. The process must be continuing from the onset of the management plan based on the owner's objectives to the dissemination of monthly and annual financial reports for the owner's records.

Meetings between the owner and the management company should be set up on a regular basis. In these meetings, topics such as major repairs, personnel problems and rent collection can be reviewed. In-between meeting, managers must communicate serious problems with the owner immediately, so they can be addressed in a timely and cost-effective manner. Constant communication is essential to the process of management. ❏

The Need For Both Asset And Property Managers

When owners of large portfolios of investment properties need to make strategic business decisions involving management of these properties, they will usually call on asset managers. Areas of concern are overall leasing strategy involving rental rates and tenant concessions, in addition to repositioning or redevelopment, tenant mix, managing bulk service contracts.

There will be owner oversight to the manager's actions, but the asset manager usually controls such matters as contracts, leases, and capital improvements for portfolio properties and is directly involved in implementing strategies involving financing and tax or litigation-related issues. The asset manager will also be responsible for maintaining communication with lenders and equity partners with respect to financial reporting, debt negotiations, and significant operational issues.

The asset manager also can be expected to provide basic administrative services, including information systems support, in-house legal counsel, financial accounting, coordination of required appraisal, and preparation of annual operating budgets. The manager also may plan and coordinate exit strategies–sale and disposition of real estate. Finally, the manager will be responsible for overseeing property management personnel.

The Property Manager

Property management responsibilities differ from those of the asset manager. The property manager has a more tactical focus, dealing with the day-to-day operation of individual properties. These responsibilities include: overseeing repairs and maintenance, security, and cleaning operations.

Finance-related responsibilities of the property manager include tenant billings and collections at individual properties; lease negotiations; vendor contracts; cost control for property operations; and maintaining appropriate insurance coverage. They also handle tenant relations and deal with on-site issues such as space and leasing requirements. Finally, the property manager maintains accounting records and performs necessary inspections.

Property managers also may be called on to handle legal matters relating to building and tenant interests and to ensure compliance with local laws and ordinances. Finally, the property manager is the conduit by which information about each property and its operations passes to the asset manager. ❑

Increasing Market Value

Investors purchase residential and commercial income producing real estate to make money. There are two obvious ways of making money from a property. First, the owner takes a share of the annual operating profit generated by the investment, and Second, profits from increasing the market value of the investment beyond what it would be because of inflation alone.

Management and Income

Good management has always been the most important point in increasing or maintaining annual operating profits. Being a skillful manager requires intelligent handling of the functions of buying and selling properties, rent collections, maintenance, leasing, controlling expenses, refurbishing, management accounting and more. All of this requires long "hands-on" experience in the field with plenty of assistance from the latest in administrative hardware and software. Professional property managers will do a much better job than most owners and will more than cover their fees.

Increasing Cash Flow

Since the value of a rental property is based directly on the cash return, adding value means increasing cash flow.

When small investors set out to increase real estate values, the steps are in upgrading houses, duplexes, triplexes, etc., enhancing the cash flow and therefore increasing equity when the property is sold.

When working with larger commercial investment properties, there are two major actions:

- Be aware of the things that have the potential of adding value and taking advantage of this knowledge.
- Do the required homework on the property. A feasibility analysis can measure the ability to add value. There may be many other measures that must be taken, such as market analyses, applications for new zoning, design and construction planning and a plan for marketing. ❑

Benefits Of Commercial Condos

When the word condominium is mentioned, do you always think of residential properties? Of course, most condominiums are ones that people live in. But, let's consider the other condominiums. There are all kinds. Any type of rental real estate can be converted to a condo.

There are a growing number of commercial condos, many of them professional offices. The benefits are the same as owning a free standing building used as an office. A leading benefit is the security of having an owned unit free from any problem of having to move at the end of a lease period. Like owning any commercial property, interest on loans, taxes and expenses can be deductible.

There are all kinds of condominiums. We have heard of aircraft hangers, boat marinas, high-rise parking buildings, even medical office buildings.

For example, the typical new medical condominium complex could be like this. It would have 20 to 50 professional spaces (each with street-level entrances) ranging in size from 800 to 1600 square feet. The developer offers the spaces to health care providers, among them physicians specializing in internal medicine, cardiology, dermatology, pediatrics, plastic and reconstructive surgery, and psychiatry. Dentists, podiatrists, and ophthalmologists can also be among the owner-tenants. Some spaces are reserved for laboratories, pharmacies, bookkeepers and other medical-industry service firms.

Protective Aspects

Each owner of a professional space is permitted to share that space with partners. However, each space owner is bound by a "practice protection" clause that will prevent selling or leasing to a physician or service in a different specialty from his own without giving the condominium association the right of first refusal. This clause allows the complex operators to maintain a controlled mix of tenant owners.

A key attraction is that the physicians own their space, and thereby are protected from the rapidly rising rents in nearby vertical commercial buildings.

From the patients' viewpoint, the availability of full medical services with shared resources is considered especially attractive. ❑

Your Real Estate Investment

Knowing what you can do in some investment situations can be the difference between an annual profit or loss in your currently owned commercial property or the one you intend to acquire. How you acquire it can be important.

The professional commercial real estate broker is in the position to represent a client in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. This real estate practitioner stays aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and/or tax advisor. We always recommend consulting with these professionals during the planning and closing of major real estate transactions. All can affect taxes and estate planning.

We are the heart of your professional team, creating the real estate transactions that will be needed to expand your estate. Let's get together to evaluate your present portfolio of properties, or review your plans for future acquisition.

Starting with your present position and your goals for the future, we can set out moving directly toward achieving those goals. ❑

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