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Commercial Condo vs. Freestanding Building

Which is the better investment — a freestanding commercial building or a commercial condominium within a larger complex? Each has its own unique set of attributes, and so the answer really depends on the needs, goals and characteristics of the investor.

Below is a comparison of each building type based on certain property characteristics, which hopefully will shed some light on the right property profile for your situation.

Ownership

A freestanding building is owned by a single entity (be it a person, couple, corporation, etc.) and it sits on an individual parcel with separate legal access. The most common freestanding buildings are single-family residential homes, or commercial office buildings.

A commercial condominium is an individually owned unit that is part of a larger multi-unit building with various owners. Each condo owner receives fee simple title to their unit along with a recordable deed. A condo owner also receives an undivided interest in the common areas of the project, including the hallways, parking areas, landscaped grounds, entrance or lobby. Each condo is assigned its own assessor parcel number, allowing property taxes for the entire complex to be assessed individually to each unit based on that unit's particular value. Condos can be bought and sold in a manner similar to that of freestanding buildings.

Management

A freestanding building is generally managed either by the owner or by a professional property manager whom the owner must hire and compensate. A condo complex is typically managed by a condominium association comprised of a small proportion of the condo owners chosen to represent the entire project. This "owner's association" (OA) may also choose to contract with a professional manager. Investors or owner/occupants who want nothing to do with managing or keeping up their property may want to seriously consider condo ownership, as these tasks can be completely handled by others.

Property Operating Expenses

Many investors balk at purchasing a condo when they hear that, in addition to their mortgage payment, they will have to pay monthly Owner Association dues.

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However, association dues are simply a compilation of certain property operating expenses, such as landscaping, interior and exterior maintenance, fire insurance, utility expenses, parking areas that would be equally present in the ownership of a freestanding building. Although Owners Association dues of, say, $250/month for a 1,500-square-foot office condo may seem expensive, this amount could very easily be less than the cost for the same expenses in a comparable freestanding office building. Before discounting a condo based on OA dues, a comparison of operating expenses should be completed.

Decision Making

Due to the cooperative nature of condo projects, decisions regarding maintenance, capital improvements and other financial actions are necessarily relinquished to a representative Owners Association body. Independent investors who prefer to handle their own management may not be well suited for condo ownership. On the other hand, a well-run OA will budget for necessary expenses and reserves and will keep the property well maintained and running smoothly, thereby maximizing each individual unit's value. A walk around the condo project and a few conversations with existing owners are highly recommended prior to purchasing a commercial condominium, as this will give you a very good sense of whether the OA is functioning properly.

Cost and Appreciation

Because of lower per-unit construction costs and shared common areas, condos are generally less expensive than freestanding buildings. By example, a 3,000-square-foot industrial condo would generally cost less than a 3,000-square-foot freestanding industrial building in comparable condition. Therefore, if funds are tight, condos may provide an easier path to ownership. Will they appreciate as much as freestanding buildings? This is a very difficult question as the answer depends on numerous factors, including how the project is run and maintained. In observing commercial condo prices over the last 15 years, they generally tend to mirror the movements of their freestanding counterparts and will typically appreciate (and depreciate) in a similar fashion. ❑

Negotiating The Sublease

With changes in business strategies, a major existing tenant wants to sublease all or some of their rented office space to eliminate some locations and shrink operations in others. In this situation, the problem for landlords is whether it is a better strategy to enforce lease restrictions against subleasing or to work with tenants on the theory that the sooner cheap sublease space is filled, the better for all. (In addition, another problem could be whether landlords should insist on sublease restrictions in new leases being negotiated now.)

Lease Restrictions

If there is no provision against the sublease in the original lease, the tenant has the right to assign or sublease without the owner's consent or approval. However, most leases do contain this provision. In the mid-1990s, when rents were at high levels, tenants could obtain the landlord's consent only if no other space was available in the building, and even then, the landlord might have insisted on sharing in any profit realized on the sublease. (In those days, sub-rent was often higher than the prime rent.)

Although the building owner may take the position that no consent will be given to a sublease as long as prime space is available in the building, the tenant may make some good arguments for cooperation.

First, when there is much space available all around, a tenant looking for space can find it easily. A landlord is better off having a tenant in possession, even with a sublease, because the tenant may stay when the sublease expires.

Second, the landlord takes the risk that a prime tenant with much excess space may default under the lease either by being forced out of business or because the tenant is willing to risk a lawsuit to collect unpaid rent. By being cooperative in finding a subtenant, the landlord reduces the risk of a default by the prime tenant and has the additional security of the subtenant's rent payments (even though the amount may be less than the prime rent).

Perhaps most important, the landlord may gain the reputation for good tenant relationships that can help in the competitive years ahead. Helping the tenant to shed excess space can pay off when the tenant considers renewal of the present lease. Landlords who are known for taking a reasonable approach to tenant problems, both during and after lease negotiations, are bound to have an edge when a tenant must make a choice between very similar rental space in different buildings. ❑

Unusual Real Estate Properties

In many metropolitan areas, commercial land for development is in very short supply. Developers are converting older warehousing to shopping areas, demolishing existing buildings to build new projects in areas in transition. However there may be many hundreds or even thousands of unusual parcels of property that have been overlooked. Many are ready for commercial development close to downtown areas, suburban commercial developments, and densely populated areas. Owners of many of these properties consider the property as “surplus” and have not considered development.

Some of these properties are in the inventories of city, county and state ownership and are surplus parcels that were unused in street, highway and freeway development. Others are owned by railroads.

All of these infill properties have one thing in common– they all are unusual pieces of real estate. They are peculiar shapes and sizes. One railroad parcel was 50 feet wide and 26 miles long. This parcel lay unused for many years until a developer utilized parts of it for several self-storage projects. The developer formed a joint venture with the railroad, with the railroad contributing the land and the developer his self-storage development expertise.

Throughout the country now there are shopping centers built under freeways, commercial buildings erected in the unused areas under bridge approaches. In some states, the air space above busy highways is leased and used for restaurants or other businesses that can be used by travelers.

One real estate broker contacted a railroad about surplus property in his area and was handed a stack of descriptions of over forty properties that were available. No one at the railroad was doing anything about marketing these properties.

When you see an unused parcel of land in your area, let us research it for you. We may be able set up a purchase, lease or joint venture that can change that eyesore lot into a major development. ❑

Extra Income From Campus Apartments

When an owner has an apartment property near the campus of a University, there are particular problems. The competitive situation dictates that leases be offered for one semester of nine and a half months. A twelve-month lease for students is virtually unheard of. That means there are lots of vacancies as soon as final exams have ended. (This does not apply to a few University communities where there is always an apartment shortage. In those few places, the student must lease for 12 months or have no lodging.)

There are ways that might help turn the months of vacancies into extra rental income.

First, during graduation week, the vacant apartments are rented to parents, by the management company, on 3-day or 5-day leases. The parents like being closer to the activities that attracted them to the campus than they would be in outlying motels.

Second, summer students taking courses at the university welcome the chance to rent an apartment on a week-to-week basis. This is particularly true of students and employees from other colleges who don’t have the time to search out living arrangements for, say, a six-week summer course. ❑

A Step-Down Rental

Tenants understand the need for step-ups in their leases because they recognize the inevitable upward trend of costs. There is no reason for elaborate set of definitions in the lease. The lease simply needs to spell out in a schedule the applicable period and the rent to be paid during that period.

The landlord will almost never agree to a step-down rental tied into the possible deflation rather than inflation. However, there is one instance where the demand of the tenant for a step-down in the rental might be appropriate.

When a landlord has been able to get good mortgage financing for the improvement primarily because of the high credit rating of the tenant, that tenant may argue that when the initial mortgage is fully paid off, the rental should be reduced. The cash flow to the landlord will jump substantially because the debt service is eliminated and the tenant may want a share. In effect, the tenant says that since his credit standing made the mortgage possible (and consequently created desirable leverage for the owner), the tenant should benefit as well as the owner when the mortgage is paid. ❑

Selection Of New Tenants

The property manager provides the tenant applicant with the lease application which must be filled out for the interview. A leasing agent may assist during the review process, but the final selection of tenants is ultimately the property manager and owner's responsibility.

All leasing personnel should be informed that the company does not discriminate on the basis of an applicant's race, sex, color, creed, or national origin.

The screening process helps determine the prospect's desirability and verifies financial and nonfinancial qualifications. When all information has been received, the applicant's file should be given to the property manager and/or owner for final review. Decisions made during this process are based on the following criteria:

- Impressions created by the prospect when interviewed;
- The prospect's employment history if the prospect is applying for residential space; company or business history if the prospect is applying for commercial space;
- Information gathered from verifying the prospect's references and from the completion of a credit check;
- Compatibility of the tenant to the property type.

When the application is approved, the property manager should prepare the lease and other appropriate documents that require the applicant's signature. Commercial tenants will probably have an attorney review the lease, which may require a certain amount of negotiation. Upon approval, the lease is signed, and security deposits and rent payments are collected as specified in the lease.

When an applicant is disapproved, he/she should be promptly notified. If the disqualification resulted from a credit check, the law requires that the applicant be informed of this. To protect against possible litigation, rejected applications should be kept on file with complete statements about why applications were rejected. ❑

Commercial Real Estate Representation

There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate.

A professional real estate practitioner must stay 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 CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. ❑

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A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.