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The Office Building - Suburban vs Downtown

Suburban office buildings remain many investors primary acquisition target.

These investors reason that a suburban office building will almost always be a good buy. Careful choices must be made, as there must be a demand for office space in the area and a gradual increase can be made in rents. The long-term demand for office space looks good.

Suburban vs. Downtown

Suburban office markets has outpaced downtown markets because the suburban markets have the advantage of lower cost of land and the economic feasibility of constructing smaller buildings. Consequently, the national suburban office vacancy rate has decreased.

The Overbuilt Property

When an investment property is located in an overbuilt area, the marketing effort must have good planning and direction. Just throwing large amounts of money into advertising can be a waste. Rather than broad advertising, a more direct action is required by keeping the local brokers who specialize in leasing constantly updated about the amenities of a certain property. This may be the best way to make it more marketable.

Here are some other ideas:

- Choose the management company carefully. The agency must be professional enough to give service as exclusively as if this building was the only property represented. They must truly know the unique benefits of this building and must be enthusiastic about it.
- The outside appearance and landscaping must be first rate. Before anyone can see the inside, they see the outside and it has to be inviting.
- Stay away from quick fixes, The professional approach is to stress the positive features of a building and work with potential tenants to match the criteria the tenant feels are most important to him.
- Contact all tenants in nearby buildings and invite them to compare this building to their current location. There are always some who are nearing the end of their lease.
- The management company must use imagination and do unconventional things to periodically get the building into the spotlight.

The Older Building

When you look around a community, you will usually find a number of properties that need to be upgraded. Investing in an older building, with the plan to bring it

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up to date for an increased return on the investment, must be examined carefully. This is where an experienced building inspector is needed.

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.

Here are some things to consider before the purchase:

• 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. Is the expense of these changes in your budget?

• Functional changes and mechanical replacements can reduce costs in an old building and increase efficiency. Look at the wiring–will it need to be replaced to provide safety for modern electrical and computer equipment.

• Old heating and air condition systems will usually be inefficient and cause high maintenance costs, and should be replaced.

• Aesthetic improvements as simple as sprucing up of the property 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, adding new landscaping, installing new flooring inside, installing new lighting and repainting the building inside and outside can be enough sometimes to make a quick, nice profit.

When an investor is looking for the proper investment, older commercial 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. ❏

Lease Or Own Commercial Property

Whatever the kind of property used, the user has the option of purchasing or leasing. Should you buy the house you live in, or lease it from someone else? With few exceptions, there would be an overwhelming response to “own it”. The benefits weigh heavily toward ownership. With business property, the answer sometimes may be a lease instead.

Real estate investors who enter into a long-term lease instead of buying property make a decision with implications that can have an effect on both financial and tax positions. The important difference of the long-term lease from a straight purchase (outright or with a loan) is borrowing (renting) the property itself for financial benefit.

Sometimes the choice of owning is not available and the property can only be leased not purchased. During a period of time when money is not available except at very high rates, leases may be the only consideration. Another time when only leases are practical could be with the best possible location in a large city, where institutional owners hold the land on a long-term basis.

Here are examples of some property users who must make this decision:

1. Some real estate users have a prime objective of maximum cash flow now, in commercial or residential income properties. They will be interested in securing capital, investing for maximum return.

2. Any store chain, fast food outlet, other franchise operations must use real estate in the operation. Should their money be used to purchase property for their locations or be retained for working capital and expansion?

3. An owner wanting the highest leveraged position, with the greatest interest in securing the largest gain possible from the property. This owner could avoid tax liability on current income from the property.

Preserving Capital

With a new business, the owner of that enterprise has the choice of buying or leasing the business location. In the beginning, this choice has little meaning to most. The owner most often will lease a business location, preserving capital for operation of the business. Capital is always critical in early operations and is seldom in enough supply to purchase real estate.

A Later Choice

The choice of buying or leasing remains as an alternative even later. After some years and much success, the owner may wish to expand, change locations, or just have a business location that is “tailored” to the specific needs of his operation.

So, the business owner buys a property with a small down payment. He borrows and builds a building,

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which is perfect for present and future needs of the business. In addition to the best location, there are other benefits that might help to make the decision to purchase the property. These are:

1. Like a home, the owner has the security of owning the property, and the peace of mind of knowing that no one will evict the business at some later time.

2. The new improvement (building) on the property is a depreciable asset and so provides the added benefit of tax shelter for current income from the business.

3. The interest paid on the loan is a business deduction. The difference, the amount paid to principal, builds equity in the property.

4. The ownership of the real estate gives the owner a stability and added stature in the community, increasing his financial strength.

Now, in addition to security and self-image, the owner has all of the elements of a good "leveraged" investment: Low down, large loan and depreciation of the improvements. The cost may have been fairly small. After a minimum down payment, the payments on the loan may not have been too different from the previous monthly lease payments.

The Next Buyer

Still later, the picture changes again. After using the property for ten or fifteen years, this owner might be approached by a broker with a buyer for a good property to own as a passive investment. The investor prefers a commercial building with a good tenant and a long-term lease. The broker suggested a purchase of an existing business property from the present owner who might then lease back the property.

The big change for the business owner happened over the years. Because of inflation in those years of ownership and the annual reduction of the mortgage with the loan payments, he has built an enormous equity in the property. The original down payment has now grown to a huge equity – maybe hundreds of thousands or millions of dollars!

The New Benefits

The purchase of the property was an excellent move for the business owner, when it was done. Now, with the passage of time, his position has changed. When discussing this with his Real Estate Investment Counselor and CPA, the following list of benefits for the sale of the property, then a leaseback, were developed.

1. The hundreds of thousands of dollars (or millions) of capital tied up in the real estate ownership would be released for expansion of the business, operating capital, investments, personal use or retirement.

2. The business owner's balance sheet could improve. The amount of the current real estate loans would not show as a liability and the cash would increase the asset side.

3. The seller still has the use of the original building, built to the specific needs of his business, but now it will be with a long-term lease.

4. The rent paid on the building after the transaction is deductible as a business expense, just as it was when the business first started.

5. If the proceeds of the sale are invested, the annual return may equal the rental payments on the lease, in effect making the rent on the property free of out of pocket expense.

6. The cash will be received by the seller without any loan approvals and does not have to be paid back.

7. After the sale, if the business owner reserves the right to sublet the real estate, he may be very flexible on future plans to sell the business or continue to operate it.

These benefits were all to the liking of the business owner. The only drawback was the tax to be paid on the gain in value. After his CPA computed the actual amount, the tax was minimal compared to the benefits, so the sale, then leaseback was completed.

Deductions

The sale-leaseback often accomplishes more for the seller than getting money by borrowing on the property. The seller is entitled to deduct the entire rental payment as a business expense. On a loan, only the interest can be deducted.

So, the sale-leaseback, in effect, makes the cost of the land depreciable. With a mortgage, the mortgagor can neither depreciate the land nor can the portion of the loan payment that amortizes the land (loan reduction) be deducted. Since the payments on rent are similar to principal and interest payments on a loan, this means that all of the monthly payment (rent) is put on a tax-deductible basis. This may more than compensate for the loss of the depreciation deduction, which was only on the improvements.

We recommend consulting with your CPA and/or tax attorney for any changes in the tax laws. ❏

Acquiring Land For Development

Acquiring land for development is necessary no matter what kind of market we are in. Professional real estate assemblers are always looking at and acquiring under-utilized sites within cities or in suburbs. Here are some ideas on how those professionals do it.

• **A Thorough Knowledge.** Only purchase or option property in well known localities to reduce the risk of unexpected surprises. If the locality is not familiar, seek out local professionals for their opinions.

• **Be A Follower.** Being the first to buy increases the risk of being wrong and may mean an unexpectedly long wait until values rise. It is often better to go in after values have begun to increase or after some development has started.

• **Government Maps.** Local governments often have maps and plans for projected roads and highways. These can point the way to desirable acquisitions.

• **Prepare An Acreage Map.** The map should show the ownership of all tracts in the locality and (if known) the asking price of each. This step marks the prime difference between the professional and the non-professional land acquirer.

• **Seek Out Builders.** Try to find a builder willing to let you act as an intermediary in acquiring land.

• **Option Or Installment Contract.** When acquiring property, get a firm commitment from the landowner without the buyer having to pay out cash. This can be done either with an installment contract under which the buyer can pay interest only for the period of years with a right to walk away without further penalty.

Note: An investor or investment group retained by a builder to find land is obligated to give the builder the first opportunity to buy in all cases. However, any land the builder does not want may be a good investment for the assembler since its value is likely to increase as new construction occurs. ❐

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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