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Your Real Estate Investment Check-Up

When you make an investment in real estate, it is implied that you want to make money. The cash can come from direct income from the property or from capital gains from a sale after an increase in value. Either way, the investment must be managed, considered, and watched at all times. If the owner and manager are taking care of business, there may be ways to increase the income, and the value. There is always the possibility to make a sale for the right price and terms. Keeping aware of the market might bring an opportunity to make a tax-deferred exchange into a property with more benefits for the owner.

Real estate investors often own various kinds of properties. They may have a mix of commercial, residential income, land and groups of houses. These owners have an extensive portfolio of investment real estate.

Owners of portfolios of stocks and bonds meet with or call their broker often. Like seeing a doctor or dentist at regular intervals, it makes sense for real estate investors also to meet with their real estate investment representative or counselor at least a couple of times a year. Exchanging ideas with the professional who has the daily pulse of the real estate market can be profitable. At each meeting, the investor can plan on finding out the current market conditions that will have an effect on equities that are now owned or that could be acquired.

In many cases, the owner's investment representative is also the property manager. If not, perhaps the property manager should also be present at these meetings at least once a year.

Make Notes In Advance

Planning any professional meeting in advance will make it more productive. To keep any business meeting on track and save everyone time, notes should be made in advance by the property portfolio owner or the real estate investment specialist. The following are some examples of questions or subjects that might be discussed at each meeting; or some at least once a year:

1. In what ways can the management of my properties be improved? Can any current expenses be decreased?

2. How do our rent levels compare with the others in the immediate area?

3. Have there been collection problems–are all rents current at this time?

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4. Is the current maintenance of the properties up to the best standards?

5. Has the planning department approved any zoning variances in the areas of my properties? Would it enhance the value of any property of mine to apply for a change in zoning?

6. Have any new construction projects been started nearby? What are they and what effect might they have on my properties or rents in the area?

7. Is the present use of my properties the highest and best use?

8. What improvements could be made that would increase the income?

9. Are we attracting the kind of tenants that should be in this type of property? Would anyone else be more desirable?

10. Are any properties of the type we own on the market at this time in this immediate area? What is the price and how is that price justified? Has there been any buyer interest in it at that price? Should we consider adding it to my portfolio of properties? If so, how can we acquire it, either by cash purchase or exchange?

11. Is my leverage position in all properties at its maximum potential? Would there be any benefit in a refinance of any of my properties at this time?

12. Are any properties in this portfolio suitable for a condo or co-op conversion? If so, should we do the conversion or sell the property to an expert in that field?

13. Can we offer any property for syndication? How would we handle it?

14. Which of my properties has the best set of benefits for me? Which has the least benefits?

15. Which of the properties in the portfolio would be the most desirable to dispose of at this time?

When each of the points in the meeting have been covered, both the property owner and his/her representatives should have a much better picture of the property portfolio and what should be accomplished. At this time, maybe each property owned should be graded in order of the most desirable to the least desirable to continue holding. Then the answer to item #15 will be apparent.

This can be the "bottom line" and the reason for the meeting. The goal should be set for the sale or exchange of the least productive property (to this owner) in the list of real estate owned. This might be the property of the highest potential to someone else, but of less interest to this owner because of the increase in value already shown by current estimates of worth or appraisal. This result is very satisfying since the "weak" property is identified and the goal is set to use its equity to acquire a certain type of real estate that will fit better into this owner's portfolio.

This gives a result for the owner that is seldom achieved by most investment real estate owners. At all times, there is a definite effort being made by a top real estate professional to improve the owner's position.

The problem of a taxable gain from that property need not be a consideration to this owner. The broker, working with the property owner's attorney and accountant can arrange to defer that tax by setting up a tax-deferred exchange into a more productive property. ❏

Alternative Rental Plans

When there are vacancies in commercial buildings, tenants may feel that they are in a good position to seek concessions from landlords on new leases or in exchange for extending or renewing existing leases. Landlords are apt to make deals for two reasons: (1.) The landlord may be facing high vacancy rates, and (2.) The landlord also recognizes that tenants may also be suffering from declining business and are less able to pay the high rentals of a few years ago.

The landlord will be looking for a formula or concession that will give the tenant an economic break, but at the same time allowing the owner to show a scheduled (on paper) rent roll that is sufficient to satisfy a banker who is providing financing for the property.

Some Alternative Ideas In Rentals

There can be a variation in the typical retail rent formula that calls for a fixed minimum rental plus a percentage of gross sales over a specified minimum sales volume. Here are some suggested possibilities:

• **Graduated rent.** Most people starting in business are short of money. If the negotiation establishes a graduated minimum rental that will give them a rent break in the early years, while producing the overall rental needed by the owner over the lease term both might be happy. (Be sure and check with your tax advisor and be aware of IRC Sec. 467.)

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- **Rent differentials.** There is no reason that the landlord must charge the same square footage rental for the entire leased premises. The rent charged for the showroom area and sales area may be higher than that charged for stock rooms or storage areas. In exchange for charging a lower rent for the nonsales area, the landlord may want the percentage rental on the sales area to kick in at a lower level or be at a higher rate.
- **Base year rent.** The parties might agree to a straight percentage rent for the first year instead of setting a minimum fixed rental for the first and subsequent years. Then that rent will become the base for all future years. This will allow the tenant to be assured that a slow start-up will not be a business-breaker because of the need to pay a high minimum rent. For the owner's protection, he may have the right to cancel the lease if low sales in the early months or years result in a too low rental.
- **Rent deferral.** Deferral or free rent is the worst example of graduated rents. In extreme cases, a l0-year lease could offer free rent for the first year. (It might be better for both parties if the period of free rent could come somewhere in the middle of the lease term. This can assist the landlord to "amortize" the loss over the earlier years during which rent has been paid.)

Other Suggested Concessions

Don't just limit the negotiations to dollar amounts of the monthly rent. There are other things that can be just as important to both sides:

1. **Recapture provisions.** When the tenant incurs significant costs for leasehold improvements, the owner may agree that the tenant may recoup a portion of the cost from future percentage rents (but not minimum rents).
2. **Turnkey deal.** The owner might agree to make all leasehold improvements to the premises so that it is ready for the tenant to move in and begin fixturing.
3. **Kickout clause.** A performance kickout clause included in the lease may reduce the minimum fixed rental if sales do not achieve the level mutually agreed on.
4. **Percentage rents.** The point at which gross sales trigger the payment of percentage rents may be raised during a portion of the lease term or during the entire term
5. **Escalation clause.** In the typical lease, the tenant must pay a proportionate share of increases and operating costs as well as a percentage rental. There are adjustments that can be made here. A cap could be put on the maximum amount of escalation costs each year or on the maximum increase each year. Another way might allow the tenant to deduct a percentage of escalation costs from percentage rents; this could be an excellent negotiation for a tenant who expects to show significant increases in sales volume over a period of years. ❑

Office Building Comparisons

Newer office buildings may fill up at the expense of older office buildings. Since new buildings cost more to build than the older ones, rents may be higher. The actual dollars-per-square-foot costs must be compared, along with other benefits that the tenant may receive, before a final decision is made by the tenant on staying or moving.

In many areas, there are a number of vacancies reported in office buildings. Most of this available space is in the newer properties. One of the most important jobs of a leasing agent for a building with this available space is to analyze other buildings to see if any tenant could be induced to move.

Here are some of the items for comparison:

1. What is the time factor for employees at the old location? In a business' expansion at the old location, they may have expanded to different floors or to different buildings, as more space was needed. There may be a big loss in employee time due to the inconvenient layout.

2. Maybe the tenant is planning an expansion in the next few years, which will make it necessary to rent space in the old location at then-current rentals, raising the average rental per square foot for the tenant's entire space, in a less than adequate location.

3. Don't assume that the new space rentals are not competitive. Cost-of-living clauses in the tenant's existing lease may have escalated the rent level up to the costs in the newer, more modern building.

4. The newer building represents more efficient design, better and newer lighting, modern in every way. The intangible improvements in employee morale and efficiency might overcome any slight difference in dollar-costs per month.

5. Finally, a change in location to a more, prestigious building in a better part of the community can contribute to the reputation of the tenant–and ultimately to the profitability of the business.

The tenants who could be good new tenants at the new location will usually not be aware of all of the benefits of a move until they are contacted and are given the opportunity to make the comparison. ❑

Negotiating The Termination Of A Lease

One or both of the parties to a lease of commercial or office space may want to sever the relationship prior to the end of the lease term. A tenant may want to terminate the tenancy, for example, because his business has grown since he first moved in and he requires larger quarters. A landlord may want to terminate the tenancy because there is a better prospective tenant available.

Tenant Wants To Leave

While leases normally provide for the landlord's remedies in the event of early termination or abandonment, a tenant will try to reduce his potential liability. The landlord usually will want to avoid the delay entailed in seeking his remedies in court. Here, then, are some tips on what the landlord can do to protect his interests through an amicable arrangement with the tenant.

When a tenant requests cancellation of his office lease before its stated expiration date, he must be made to realize that he cannot take this step without incurring an expense. As soon as the building manager becomes aware of the situation, he should seek out a new tenant, first offering the space to other tenants in the building who may need more space than they now occupy.

When a new tenant has been lined up, the landlord should determine the cost of altering the space for the new tenant and the amount of time from the date when the old tenant vacates to the date when his successor will move in. The landlord and the outgoing tenant then sign an agreement for the tenant to pay a flat sum consideration for early termination, taking into account the cost of new alterations and any applicable re-renting commission. In other words, the outgoing tenant agrees to pay the rent, at the rate specified in his lease, for the period of vacancy, plus the cost to the landlord of securing a new tenant.

Landlord Wants To Terminate

The owner of the building may seek an early termination of a tenant's lease because of the expansion requirements of another tenant in the same building or because of condemnation or for some other reason. Under such circumstances, the owner must expect to indemnify the tenant in some way. The following matters should be taken into consideration in arriving at a settlement with the tenant:

- The successor tenant's rent may be at a higher rate than the rate paid by the outgoing tenant.
- The outgoing tenant may incur extra expenses because of the early termination.
- The owner may realize a profit on the alterations. Besides the cost of the allocable proportion of alterations required for re-renting the space to the new tenant, the landlord must also take into account the unexpired value of the changes attributable to the original tenant.
- If the new tenant is already leasing space in the building and needs more for expansion, the new lease assures his prolonged tenancy. ❏

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