



**Rob Cassam**  
MBA, CCIM  
Owner-Broker (NC,SC)  
704-442-1744



1001 East Blvd. Suite B • Charlotte NC 28203

Phone: 704-442-1774 Ext.100

Efax: 800-571-7536

rob@charlotteNCproperty.com

www.charlottencproperty.com/commercial

## High Leverage A Benefit With Options

Leverage is the use of borrowed money to control something of value. Real estate investments for many years have afforded the investor some extreme leverage situations. Let's examine leverage. If double-digit inflation returns, controlling the maximum amount of real estate may be extremely desirable.

High leverage is an excellent benefit. Remember though, that with an option there is a problem. Options have an expiration date. If you haven't gotten the desired increase in value by the time the option expires, you must make the choice - buy the property and wait longer, or let the option expire.

An option is simply a contract that gives the purchaser a right to buy a certain property at a certain price for a certain period of time. Sometimes a seller will sell an option to purchase his property because the amount of money paid will solve an immediate problem, and it really does make him feel that the property is sold, or will be sold.

### Always ask yourself a few questions before buying an option:

- Will you have enough money to exercise the option at the expiration date if no loans are available?
- Do you think the property will increase substantially in value during the option period?

- Will the profit be large enough to chance the loss of a small investment in the option on the property?

Suppose you buy an option to purchase a property during a period of the next three years. You have set the option price at today's market value and put up only about 10% of the ultimate purchase price. You wait three years and find that you guessed right! The property has increased in value by \$100,000. You can now make some choices on the next move:

- **Exercise the option.** You can buy the property. Maybe you can borrow the amount of the purchase price on the land and buy for no money down. To sell at a long term gain, you must now hold it for six months, or longer.
- **Sell the option.** You might sell the option for the \$100,000 cash to someone who wants the land. This would be an immediate long term gain since the option has been owned for more than the minimum time period.
- **Settle the option.** The profit is yours because the present value is higher. What if the original owner who sold the option to you now sees more future value in the property and would like to continue owning it.



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This publication is not a solicitation but is an information service from this office.

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When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

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The original owner might buy the option from you or settle it with you in some other way. Perhaps a joint ownership could be arranged, with both of you taking a further holding position for more profits in the future.

### **The Risk**

Remember, the market tends to reward those who take risks. When you minimize risk too much, play it too safe, you may give up the chance for larger profits.

### **See Us For Investments**

Serious real estate investors may want to own real estate for cash flow, tax shelter and reasonable growth. Maybe you would also like to invest something for a long term growth, such as land speculation. Come in and see us. Perhaps we can help you with choices and do some of the research for you. ☐

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## **Leased Property—An Estate For Years**

When we write or talk about real estate “investments” it is usually with the idea of ownership of the property. When you own the investment property, the opportunities for profits and cash flow from it are thought of as rent paid by a tenant to the owner. The owner also has a potential profit that can come from the later gains when the property is sold.

Since the emphasis is on ownership, the average real estate investor might not think about the cash flow and potential profits from a property that is leased rather than owned. However, there are investors who specialize in making profits, sometimes big profits from properties that they do not own.

This cash flow from a lease can be extremely interesting. Often the lessee making a huge profit has a relatively small cash investment in the property.

If you were the lessee of a building and wanted to make a profit on a possible sublease of some of it, who would your “customer” be?

### **The Usual Lessee**

Take the position of the person acquiring property for use in a trade or business. For this person, the fundamental advantage of leasing over purchasing is the fact that the entire amount expended for leasing is currently deductible. On the other hand, if the property were owned, the owner would not be able to deduct any part of the purchase price. His entire cost would have to be capitalized, and could only be recovered through depreciation of the cost of the improvements over their life. The remainder would only be recovered on the disposition of the property.

### **The Estate for Years**

A lease is defined as a contract between the owner of the land or building (**landlord or lessor**) and a tenant (**lessee**) in which the lessee agrees to pay a stipulated sum (rent) for the use and enjoyment of the property for a specified period of time. This is, for the lessee, very much like an ownership, and is also called **an estate for years**.

A lease is a complicated legal contract and it should not be entered into by either the lessor or lessee without professional assistance. All leases are different and so we cannot cover all of the possible combinations of items in a lease in this publication.

We can cover just the elements that can result from negotiating leases and subleases for profit.

### **The Original Lease**

The original lessee may lease a property for a certain specified monthly rental amount. This lease is with the owner of the property.

As an example, what if a commercial building is leased for \$10,000.00 a month? If the lessee could sub-lease the same property to another renter-user for a rent of \$11,300.00 per month, then the original lessee would have a cash flow of \$1,300.00 from this situation which is often called a “sandwich” lease. The original lessee is “sandwiched” between the owner and the user of the property.

This original lessee still pays the original specified monthly rental of \$10,000.00 to the owner, but since he is collecting \$11,300.00 from the sub-lessee under a separate contract, the difference of \$1,300.00 is a monthly profit for him.

### **The Right to Sublease**

As we pointed out, you need professional assistance to prepare the lease. If a “sandwich” situation is contemplated, a provision giving the tenant the right to sublease space is an absolute necessity in the lease agreement.

It is customary, in landlord prepared “form” leases, to preclude assignment and subletting. The ideal position for an active landlord who intends to provide competent continuing management to his real estate is to maintain this clause intact throughout the lease negotiation and thereby provide himself complete control of all assignments and sublettings, since none can be accomplished without his prior approval.

The usual original reason for the lessee to place the



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provision to sublet into the contract is the question about the future amount of space that the original tenant will need. If a tenant believes that he will need less space in the future, a sublease clause can be provided to solve the problem. The owner will usually agree in this situation, since the alternate provision might be for a cancellation of the lease.

A good counter-offer from the owner in this situation might be a “right of approval” of a sub-tenant. There might be other things that the owner wants into the lease regarding the use, etc., of a sub-lease tenant. All must be negotiated.

### The Profits

- Our example of the commercial space leased for \$10,000.00 and sub-let for \$11,300 showed a \$1,300 a month cash flow.
- One speculator, when looking through an area for a commercial property, noticed a well-located house with an owner’s “for rent” sign. He inquired and leased the house for his own use. A few months later, he moved from the property, but was able to sub-lease the house for a \$500 a month profit.

*(Note: This is getting into a dangerous area. The original lessee would probably be liable for any damages to the home. Take care!)*

- A retail store operator leased a 30,000 square foot retail location, knowing that it was too large for him. By negotiating for the entire space, he was able to get

an excellent price per square foot - a wholesale price based on his financial strength and ability to lease the large space.

The retailer used 15,000 square feet, as originally planned. The balance of 15,000 square feet was remodeled (by the retailer at his expense) and sub-leased to a number of smaller retail operators, who paid a premium price for their store area.

The original lessee ended up with enough income from the sub-leased space to pay all of the rent on the building. He had negotiated a situation where he had free rent for himself in an excellent downtown location.

- One lessee leased a commercial building that had been used entirely by the offices of an insurance company as a regional location. By taking the entire building, he was able to work out the same rental rate that the insurance company had paid – also on the entire property

With very little in changes, the lessee then leased each room or suite of the building separately to various professionals - attorneys, insurance agents, real estate agents, etc. His cash flow from the “sandwich” lease situation amounted to a profit of \$13,000.00 per month - for leasing and managing a property that was not owned, and in which he had little cash investment.

Making these profits may take a little ingenuity on the part of the lessee. He may have the imagination to see the uses of a property that the owner does not, or would not have the time to do himself. □

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## What Is The Future Of Investments?

Which way is the right way in real estate investments in 2016? What is the future in these investments? An answer to these questions can be an interview with an interested professional real estate broker who can act as a real estate investment counselor. Each prospective investor can be interviewed in depth to find out specific needs in an income property. At the same time their needs are being evaluated, the broker will also communicate what benefits are available in various properties and how to identify them.

Some considerations should be given to the risk of loss for each age bracket of investor. Should an older investor purchase a property with the smallest down payment and highest leverage position? This will limit cash flow and may cause the property to have a “negative” cash flow. Is this what they want-or do they want cash flow from the property?

How about the younger investors? Are their objectives for long-range estate building or for current cash flow?

Would they be more willing to take chances with a marginal investment that might bring big returns later?

Each investor must decide these answers for himself or herself. But, only after enough information has been furnished so that an intelligent decision can be made.

When a new investor has a better idea of the type of property that will do the right job for him/her, or them, then and only then should they be exposed to the market place and shown specific properties. Now the investor or investors can evaluate the various benefits and risks for the information shown on each property and apply the information to their own situation.

What is right for you? A new rental unit? A strip center? A one hundred-unit apartment property? Perhaps you should have five or six apartments or commercial properties in scattered locations. Real estate counseling can show you that you can choose which is right for you and know the reasons why it is right! □

## Methods Of Land Acquisition

The acquisition and improvement of land is a large-scale operation and requires large amounts of capital. This has created methods of land acquisition that gives the developer access to and control over a large enough tract to make development economical without requiring an initial outlay of all of the capital necessary to acquire such a tract.

From the point of view of the landowner, the disposal of a large tract at a good price may require a formula that will encourage the developer to commit improvement and development money for part of the tract that will build future value into the entire tract.

This may be accomplished by the following:

- The developer sets up a master plan that sets forth the general scheme of development and submits it for the approval of the owner.
- The developer and owner enter into an agreement setting forth the acreage prices for the entire property.
- Owner and developer agree on the number of years over which the full development is to be completed.
- To protect the owner against freezing of his property, the developer firmly commits to buy a predetermined number of acres each year.
- If the developer fails to meet this schedule, the owner is released from his commitment.

### A Development Agreement

Another way of handling the problem is for the developer to share the net profits from the land development with the landowner. This can be done by a “land devel-

opment agreement” in which the developer agrees to perform the platting, the laying out, the installation of lot improvements, and the promotion of the subdivision. The landowner agrees to accept a percentage of the sales price of each lot, with a fixed minimum guaranteed. For example, the developer agrees to pay net to the landowner 25% of the sales price of each lot sold, with a minimum of \$25,000 per lot.

With this kind of arrangement, it is important to protect the landowner from finding his land cluttered up with liens left by a subdivider who became insolvent. The landowner should consider confining the developer or subdivider to a small tract of land at a time and give him “rolling options” to acquire additional parcels at intervals over a period of time. Failure to keep up with this purchase program results in loss of future options. The land that has been optioned but not purchased is not subject to liens against the developer.

### A Liability for Not Proceeding With Development.

In one case, a jury found that a village breached its contract with a real estate developer calling for the village to acquire property and convey it to the developer for construction of apartment houses and a shopping center, all conditioned on obtaining financing from HUD. The village repudiated its explicit undertakings, to acquire and convey property to the developers. HUD had granted the main application and was in the process of considering the other grants involved, so the village could not back out of its promise. [Heritage Commons Partners v. Village of Summit, 730 FSupp 821, (ND Ill. 1990)] □

## 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. □



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.