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Lenders Need Professional Property Management

Whether times are good or bad, lenders always have foreclosed properties in inventory. During a recession the inventory may be high. One of the problems that banks and insurance companies have is disposing of this real estate owned (REO). They are faced with the decision of whether they wish to dispose of the property immediately or hold it for a period of time to hope for an increase in value. They would like to see the value of the REO increase to equal the loan amount.

These lenders are not professional real estate investors but money managers. Therefore, they are reluctant to invest any additional money in the properties. This problem is compounded because a troubled property needs more attention than does a healthy one. It would not have been in foreclosure if it didn't need help.

The solution might be a service joint venture. This type of contract with a real estate firm allows the lender to minimize management fees until the property is generating cash flow again.

Lenders Getting Together With Asset Management

The service joint venture is a form of incentive compensation by which the lender retains an asset management firm as its agent, with the firm agreeing to defer a portion of its fees until payment can be made out of future cash flow. The relationship may be a straight principal-agent one, or a new joint venture can be created in which both the lender and the management firm are partners. Some lenders who want to avoid a formal ownership position in distressed property desire this approach.

The differences between the fee structure of a service joint venture and more traditional arrangements are as follows:

- **Management fee.** In a service joint venture, the agent receives anything from a below-market fee to no fee at all until the project achieves a specified level of net operating income (NOI). After that, the asset manager receives a designated portion (for example, 50%) of the NOI over the threshold amount. By comparison, the traditional management firm receives either a fixed fee or a fee based on a percent of the gross income.
- **Lease-up fee.** In a service

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joint venture, the agent may receive anywhere from a full leasing fee to none at all. The variable relates to the type of property involved. In the case of an office building, retail property, or industrial project, the agent normally receives the full market fee because payment is usually a commission rather than a straight salary. On the other hand, for residential properties, the fee often is deferred until a future date.

- **Commissions upon sale.** In a service joint venture, the manager receives a substantial portion of the sales price over a threshold price, together with a negotiated commission that is slightly below the traditional percentage. By comparison, a traditional arrangement gives the agent a higher percentage of the total sales price but no share of the amount over a designated threshold.
- **On-site marketing and management.** Here, both the service joint venture and the conventional agent receive a fee as provided for in the property budget.

The value of the service joint venture is that the management company is co-opted because it receives incentives in exchange for fees. In this way, the management company shares the objectives of the lender to maximize NOI and value as fast as possible. ❑

Having Knowledge About Commercial Leases

A lease is an integral part of many real estate investments. It should outline all the obligations of the tenant and of the landlord. This sounds simple, but many questions arise. If, for example, property taxes increase, does the tenant pay all of the increase or only part of it? If the property must be modernized, who pays for the improvement? Can the tenant be moved out during the renovation? If the costs of servicing the property rise, should the tenant pay none, all, or part of the increased costs? How should inflation be handled—with automatic rental increases? With increases tied to some index, perhaps the Consumer Price Index?

Kinds Of Leases

Here are some of the variations of leases used on commercial and industrial properties:

Flat Rate Lease. This is the traditional lease in which the tenant agrees to pay a flat periodic rate for the term of the lease. This might work with a very short lease, say one year.

Net Lease. Some investors try to protect their net income flows by requiring the tenant part (double net) or all (triple net) of the expenses. For example, the tenant may pay the property taxes; or property taxes and insurance; or property taxes, insurance, and all maintenance and operation expenses. When a net lease is mentioned, always ask what the landlord pays and what the tenant pays.

Sandwich Lease Or Subordinated Lease. The tenant leases all or a portion of the property to a third party who pays to the original tenant. The sandwich lease may be at a rate slightly higher than the original lease payments, thus allowing the tenant to make money from such an arrangement. For this reason, some leases do not allow subleasing.

Percentage Lease. The amount of rent is related to a fixed amount, plus a share expressed as a percentage of the gross or net sales or profits of the business to be paid as additional rent.

Ground Lease. Only the land is rented. The tenant owns the improvements. When the lease ends, provisions are made for allowing the tenant to buy the land or the landlord to buy the improvements.

Leasehold Estate. The value of the lease to the tenant. If the tenant has negotiated a rent below market the tenant has a valuable right (perhaps by subletting at market rents). If the rent is above market the landlord has an advantage, but if the tenant is a strong, credit-worthy tenant the lease may be subject to renegotiation.

Index Lease. The lease amount is related to an index and changes as the index changes. For example, banks located in shopping centers cannot be charged on the basis of percentage of sales because there are none. In such cases an index such as the Consumer Price Index might be used.

Renegotiable Leases. The rents are subject to review and renegotiation at a particular event or after a given number of years. These are usually related to inflation measures and indices.

Improperly drawn leases may not produce enough income to cover the costs of owning and operating the property. And long-term leases in particular present problems when prices, costs, and money rates are fluctuating. There is no substitute for a lease prepared by a skilled professional. ❑

Combining A Tax-Free Exchange And A Leaseback

Here is a moneymaking transaction that can be used by many business owners who also own the real estate where that business is located. In any community there are dozens, even hundreds, of property owners who can utilize this formula.

In certain circumstances, it is possible to combine a tax-free exchange with a simultaneous leaseback. The purpose is to free up frozen equity in a property that the owner wishes to continue to use for business. The freed-up capital can then be used to acquire other income-producing property or for personal purposes. By utilizing the tax-free exchange, the property owner can avoid laying out any cash or paying any income tax. (There will be some cash required for escrow fees and commissions.)

• **Example:** Consider the case of an insurance broker who purchased a small one-unit office building some years ago in his home town in which to conduct his insurance business. The initial purchase price was $75,000, of which this owner put up $25,000 in cash and took out a $50,000 bank loan. As the years passed, the property appreciated so that it now had a market value of $150,000, while the mortgage has been paid down to $30,000. The owner now has equity of $120,000 that he feels can be put to more productive purposes than just being invested in the office building.

Seeking to put the equity to work, the insurance broker decides to have his real estate broker find a suitable like-kind property for which the office building can be exchanged. The exchange could be simultaneous with a leaseback so the insurance broker can continue to operate from the same location.

The real estate broker locates an owner of a small apartment property who wants to sell. That building has a current market value of $300,000 and is subject to a mortgage of $180,000 leaving an equity that matches the equity of the insurance broker's building. The apartment owner wants cash but is willing to be part of a three-way exchange in which the apartment is traded for the office, which will then be sold to a third party for cash.

The real estate broker then finds a third party who is willing to pay $120,000 for the equity in the office property and assume the $30,000 loan. The office will then be leased to the insurance broker on a long-term basis at current market rent.

The transaction is closed via a three-party exchange.

Benefits

The owner of the apartment receives all cash for his equity.

The insurance broker has acquired an income property worth twice as much as his original property. Assuming that the return on the apartment investment is higher than the existing mortgage, the cash flow from the apartment property is likely to substantially exceed the rental payments that this owner must pay for the office space.

If the apartment property and the original office building appreciate at more or less the same rate, the insurance broker has doubled the appreciation potential of his equity.

Depreciation

The basis for depreciation increased by $150,000 for the insurance broker after the exchange. He acquired a property with a loan of $180,000 and was relieved of a $30,000 mortgage. The difference of $150,000 is added to his old basis. He then reallocates the basis between land and improvement to compute his depreciation on the acquired property.

The recovery period for depreciation will also improve. The new property is residential income with a recovery period of 27.5 years. The property traded was commercial with a depreciation schedule of 31.5 years or 39 years, depending on when the property had been placed in service. ❏

1031 Exchange Rules and Timelines

There are 2 timelines that anybody going for a 1031 property exchange should abide by and know.

The Identification Period: This is the crucial period during which the party selling a property must identify other replacement properties that he proposes or wishes to buy. It is not uncommon to select more than one property. This period is scheduled as exactly 45 days from the day of selling the relinquished property. This 45 days timeline must be followed under any and all circumstances and is not extendable in any way, even if the 45th day falls on a Saturday, Sunday or legal U.S. holiday.

The Exchange Period: This is the period within which a person who has sold the relinquished property must receive the replacement property. It is referred to as the Exchange Period under 1031 exchange (IRS) rule. This period ends at exactly 180 days after the date on which the person transfers the property relinquished or the due date for the person's tax return for that taxable year in which the transfer of the relinquished property has occurred, whichever situation is earlier. Now according to the 1031 exchange (IRS) rule, the 180 day timeline has to be adhered to under all circumstances and is not extendable in any situation, even if the 180th day falls on a Saturday, Sunday or legal U.S. holiday. ❏

Checking Prospective Tenants For Commercial Centers

There are many vacancies in commercial properties. Owners must think about this first when checking a prospective tenant. Will the tenant's business survive? When you have a prospective tenant for a commercial center, you must consider whether that prospect would be a good tenant. There are two key standards to apply: (1) the prospective tenant's financial stability; and (2) the prospective tenant's potential for success.

Financial Stability

The prospective tenant must be able to afford the rental that you set. Its overall financial condition should be sound. Among the first things you'll do is to see if the prospective tenant pays its bills on time. Having a reputable credit agency do a credit check on the tenant can easily check this. It is also wise to talk to the tenant's main suppliers and its current landlord.

An examination of the tenant's assets is also essential. Ask to see the tenant's financial records, study them carefully, and discuss with the prospective tenant's accountant any questions you may wish to have clarified.

Potential For Success

Once you are satisfied that the prospective tenant is financially stable, you must ask the question: Will the tenant be successful in your center? To answer this question you must determine the following:

- The tenant's reputation at its present location.
- The tenant's sales volume. In the retail business, a turnover of stock at the rate of four to five times a year is considered good.
- The trend of the tenant's sales. Has the tenant's sales been increasing from year to year?
- The type of merchandise the tenant will be selling in your center. You'll look to avoid duplications with other tenants in the center.
- The profile of the tenant's average customer at its present location.
- How efficiently is the tenant's business now being run? Is the efficiency or inefficiency likely to continue?
- The nature and extent of the tenant's advertising.

No Track Record

The preceding is for the prospective tenant who has an established record, who has been in business and offers tangible evidence of performance. But what about a newly owned business that wants to rent space in your shopping center as its first-ever place of business?

You should appraise this kind of prospective tenant by using the same two key standards: financial stability and potential for success. But instead of looking at past records, you will be predicting and forecasting and making judgments about the prospective tenant's ability, ideas, and business expertise. It is a riskier situation for the center's owner-manager but a totally new business might generate totally new interest in the center—it's not the same old merchants merely doing business from a new location. ❏

Real Estate Investment Consultants

When you need professional advice and help in commercial real estate you must come to our office. We are experts in values and knowledge of the entire market in this area. If you have been looking for a certain type of property we probably have the full information on several like it already.

Today's investor in real estate must have a grasp of market conditions and potential that is usually beyond their own available time to attain. Investors need assurance about the true condition of the market. With increased competition, the market place is becoming more complicated. As your professional commercial real estate advisors, we are in the position to represent you in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate

More investors are turning to real estate consultants as a means of providing a sounding board for their ideas as well as expertise in the planning and construction stages for their projects.

Feasibility studies are essential for commercial office, industrial, resort and hotel investors. With this kind of information, planning is better and there is less chance for error.

Real estate investing is not just the structure and the land. It is investing in the type of property that you want at the price and terms that suit you at the time you want to make the purchase.

We can be your consultants. ❏