THE ENCYCLOPEDIA OF

Commercial Real Estate Advice

How to Add Value When Buying, Selling, Repositioning, Developing, Financing, and Managing

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Contents

Encyclopedia Topics

ENCYCLOPEDIA TOPIC C
Raising Investor Partners 145

ENCYCLOPEDIA TOPIC D
Property Ownership Entity 161

ENCYCLOPEDIA TOPIC E
Selling 205

ENCYCLOPEDIA TOPIC F
Repositioning 239

ENCYCLOPEDIA TOPIC J

Foreword

For over 20 years, I've invested in commercial real estate in nearly every section of the United States and have taught thousands of everyday people how to successfully invest in large apartment buildings, shopping centers, office buildings, and self-storage facilities, and the list goes on.

When I first met Terry Painter in 2004 at my favorite Italian restaurant in San Francisco, my commercial real estate business was experiencing a bit of out-of-control growth. I needed to talk to him about a 140-unit apartment complex we were purchasing in Dallas, Texas. We had just been within days of getting our financing approved and the lender, without warning, backed out. On that day and until today, I still wonder how a guy who's so intelligent can have such a witty sense of humor. Typically, people as sharp as Terry aren't very funny.

Well, to make a long story short, and humor aside, Terry was the smartest finance guy I ever met. But not just book-smart; Terry had gleaned his wisdom from the most valuable school one could attend—the School of Hard Knocks. He could virtually read through our deal's financial statements and share with us what the numbers truly meant from not only a rate of return perspective, but a human and emotional perspective. It was at that time that I started learning the importance of closely working with people who were smarter than me. Just to let you know, Terry came to the rescue on that Dallas deal and closed on a loan for us in 38 days with zero issues. Since then, he is the first person we call when a commercial loan is needed—pretty much anywhere in the United States.

Some of the best deals our group got involved in were the ones Terry advised us to pass on. Sometimes the greatest value is exiting at the beginning a deal that could be a time bomb. And likewise, many deals that Terry advised us to move forward on were personally life-changing deals for us and many others. Terry was, and has always been, the smartest guy in the room. Period.

The Encyclopedia of Commercial Real Estate Advice is a serious bottom-line book about making sound business decisions concerning buying and selling a commercial property, raising money from investors, deal due diligence (most important, in my opinion), developing from the ground up, repositioning a property to its highest and best use (my personal favorite), leasing and management, and, of course, financing. It's probably the most useful advanced real estate book I've ever read.

For Terry to pour his vast real-world knowledge and passion into this book is a true blessing to any reader or student of this great business called commercial real estate. Terry is more than just a great lender, though. His deep and practical command of the commercial lending world is more than just concepts. His advice is from years and years and hundreds of closed transactions all over the United States, helping investors (perhaps just like you!) reach lifetime financial targets and lifestyle goals. To me, and perhaps you, that's what life is about. My advice to whomever has picked up this book is to get someone who's smarter than yourself on your team. That person is the author of this phenomenal book.

Peter Harris, best-selling author of *Commercial Real Estate Investing For Dummies*
CommercialRealEstateInvestingForDummies.com

Introduction

Congratulations! If you are reading this book, you are a very lucky person. If you are already investing in commercial real estate, thinking about it, or working in this field, you are a member of a very exclusive group. According to the IRS, less than 8% of all Americans who file tax returns get to invest in income property and under 3% own commercial investment real estate. And if you work in this industry like I do (I do commercial mortgages), well, I hope you think it's fun, as I do, and, might I add, never boring.

As an investor in commercial property, you get to wake up in the morning and say to yourself, "What can I do to this property to add value?" Maybe you have found a Class C minus apartment complex in an up-and-coming neighborhood. Yes, get rid of the slow-paying and no-paying renters, and the ones who have rusty bikes and junk on their patios. Then do about $4,500 per unit in cosmetic upgrades and the rents can be raised $100 per month. Just with those ideas you can be on your way to increasing the property value by 20% or more in five years. I know of no other investment opportunity that is designed like commercial real estate—one where you can choose the right property, add value, and be rewarded with a pay raise, increased equity, and amazing tax benefits.

Remember when you just had a day job? You only had one source of income—the paycheck. With commercial real estate, you get to have *four* sources of income: rental income, rental increases, appreciation, and depreciation (I know, how can something appreciate and depreciate at the same time? Only in America.) Oh, but wait! There is actually a fifth one—leveraging your equity tax free into a larger, more profitable property by doing a cash-out refinance or a 1031 tax-deferred exchange. These are covered in detail in Chapter 5.

Is commercial real estate a better or safer investment than the stock market? Well, this is really comparing apples with oranges. Commercial real estate is slow moving. It just doesn't have wild swings from one day to the next like the ones stocks are known for. It is unlikely that you will ever lose 25% of your equity or, for that matter, gain 25% as stocks can over a year—or, even worse, experience a drop of 12% in one week as the Dow did on February 28, 2020, as fears of the COVID-19 crisis impacted the world.

Commercial property investment certainly has its risks, which are explained in detail in Chapter 1. One major risk is choosing a higher-risk property type. Unless you have experience and a nice chunk of cash, you might want to avoid hotels, retail, and office properties. Recessions consistently seem to give these properties heartburn. Oh, and I had better add Class C minus apartment complexes in blue-collar neighborhoods to this list. Boy, do they take a lot of mothering, complete with nagging tenants to be nice to each other and pay the rent. During the Great Recession and the coronavirus recession, these properties had the most slow-paying and no-paying tenants in the multifamily sector due to job loss. Class A, B, and C apartment buildings in good neighborhoods had a very low rate of default.

Recessions can actually offer a bonus when buying commercial property. Many of my clients can't wait for the next one. They have cash put aside to snatch distressed properties at a discount. Many of my experienced clients are careful to recession-proof their properties. Chapter 2 gives you 10 tested methods of doing this. Just one of them, structuring the property so that it can break even at 75% occupancy after paying all the expenses and the mortgage, can make your property bulletproof during a recession.

Actually, in my experience the highest risk is taking shortcuts on due diligence when buying, and getting married to a property who is not who you thought it was. To avoid falling into this trap, be sure to read Chapter 3, especially the 11 due diligence mistakes to avoid.

Unlike investing passively in stocks, investing in commercial real estate is a hands-on business. What causes stocks to go up and down is the performance of the companies they represent and the whims of investors buying and selling each day. Conversely, commercial real estate depends on your entrepreneurial skill. This is what I love the most about it and why I am writing this book, which is chock-full of solid, tested advice on how to make the right decisions and avoid pitfalls when buying, selling, repositioning, developing, financing, and managing commercial real estate.

When my editor, Richard Narramore, contacted me to see if I would be interested in writing this book, my first thought was—"sounds interesting." My next thought was: "Hey, wait a minute, this is my book." Why? Because for 23 years, I have lived and breathed commercial real estate. I have financed just about every type of commercial property—from memory-care facilities to a biodiesel plant—during every economic cycle. I know the pros and cons and the quirks of just about all of them. I know that a light-industrial complex will survive better than an office complex during tough economic times. That for the newbie, apartments are one of the easiest types of property to learn about, but that they can be alarmingly risky, since managing them is a bear. That self-storage is a much better investment for the beginner, as it is easy to manage and usually highly profitable at 85% occupancy, but that self-storage properties are difficult to buy. I have learned that owning a commercial property out of state quadruples the risk, and that if you do not have any working capital that's an even bigger risk. Did you know that smaller property management companies steal from the properties they manage more often than you would think? There are 11 very creative ways they do this, outlined in detail in Chapter 12.

I have taught seminars to new investors about how to choose the right commercial property, how to finance it, and how to recession-proof it. I have trained commercial realtors on how to avoid having their deals crash and burn after they have put over a hundred hours into them. I have assisted many of my clients in putting together financing proposals for repositioning all kinds of commercial properties. One of my deepest passions is working with developers—they are amazing people! They start out with an idea, which leads to finding the right piece of land. They then run some numbers. This leads to a design drawing. Next they mix in thousands of hours of work and a lot of brick and mortar. They then get to walk by the bustling property someday with their grandkids and say—"I built this!" Read Chapter 8 to find out if you have what it takes to be a developer.

At my companies, Business Loan Store and Apartment Loan Store, we finance all types of commercial real estate, but we are also advisory firms. I love assisting our clients with making the best decisions based on their long- and short-term financial goals. You would be surprised how many are sitting on the fence on what those goals are. What? You don't know yet if this is going to be a fix-and-flip or a long-term hold? From a lending perspective, my work is forensic in nature: looking under every rock, and sometimes bringing shock and awe to borrowers and their real estate brokers. "Oh, you didn't know that was hiding under there?" I love crunching the numbers: discarding the fiction and uncovering the facts. I do not get to fall in love with a property at first sight. But some of my clients do just that.

Some of the subjects covered in this book are why wealth grows faster using other people's money, how to value a property in 15 minutes, how to fake it until you make it when raising investors, why it might be better to do a cash-out refinance than selling, how to get the most bang for your buck when repositioning and developing, trade secrets on getting the best rate and terms on your commercial loan (lenders are not going to like that I have disclosed their secrets), and whether it's better to self-manage or to hire professional management.

THIS BOOK WILL SAVE YOU TIME AND MONEY

Many experts will tell you that anyone can begin investing in commercial real estate. If that were true, then everyone would be doing it. The problem is that commercial real estate is just not simple. Also, it takes a substantial amount of money.

On the other hand, if would-be investors only focused on how complicated it is and how much time it takes to do it properly, few would ever get started. The advice in this book is designed to save you time and money. Much of it comes from what I have learned from working on deals with highly experienced commercial real estate investors. But in the seminars I found myself taking on over the years, I am sure I've taught well over a hundred enthusiastic inexperienced investors, many of whom had found a great property to buy. Most in this group just didn't know how unlikely it would be for them to succeed. Most didn't even have enough cash to come close to covering the down payment. But they were so driven by a dream that I found myself joining them in their madness. Guiding these entrepreneurs, and helping them avoid hazards, has given me most of the material for this book.

HOW TO USE THIS BOOK

There are eight parts to this book, each representing a major topic. Each one starts out with informative chapters followed by an encyclopedia where you can look up individual subjects that interest you pertaining to the topic. Each encyclopedia subject is not just defined, but has sound nuts-and-bolts advice. With 336 encyclopedia subjects on just about everything from *A* to *Z* on commercial real estate, you can go back to the encyclopedia sections over time when you need a resource on a subject. As a bonus, there are 136 Time and Money Saving Tips spread throughout the chapters and encyclopedia sections. Commercial real estate terms that are in *italics* are included in the encyclopedia sections, where you can learn more about them.

CHAPTER 1

Who Are You When Buying a Commercial Property?

It might seem strange for someone writing a book on commercial real estate advice to begin the first chapter by asking the reader "Who are you when buying a commercial property?" I am asking you this question because I have found it to be the most important question buyers of commercial real estate can ask themselves to save time and money.

Some of my buying clients clearly did not ask themselves this question. Many seemed to lack confidence. They spent so much time evaluating the wrong properties, and so many different types of properties, that I found myself spinning in circles with them and getting dizzy. Did they want to buy properties close to home or out of state? Properties that did not need any work, or those they could add value to? They couldn't make up their mind. For some, all the choices seemed to be too risky. They just could not decide on the level of risk they could live with. After bumping into endless walls, many found themselves quite miserable. Some just quit the process. Some made it through and actually closed on a property. But many of them ended up owning the wrong property in the wrong place at what turned out to be the wrong price.

And then I have had clients that clearly knew who they were and what they wanted from the beginning. Most of them were experienced. It seemed as though they were born to invest in real estate. I had fun working with investors in this group; we shared the love of the deal. They also bumped into lots of walls because that's what you do when you buy commercial investment property. But they had a blueprint to follow that kept them going in the right direction.

The goal of this chapter is to help you understand which category of investor you fall into, and how to determine the risk level of a commercial property you are interested in purchasing.

SEVEN TOP CHARACTER TRAITS OF EXPERIENCED COMMERCIAL REAL ESTATE INVESTORS

1. Are You Determined, Confident, and Unstoppable?

In 2005, an LAPD officer named Kelly Fabros called me for financing. She had taken a course called The Maui Millionaires and decided at the age of 32 that she was going to retire from the force. She was going to move on to becoming a millionaire through commercial real estate investments. Our first conversation went something like this:

> "Hey Terry, I have found the perfect 164-unit apartment complex called Riverwalk Apartments in Wichita."
>
> "How much is it, Kelly?"
>
> "Six million eight hundred thousand."
>
> To get people who are not qualified off the phone fast I always ask them two questions:
>
> "How much do you have to put down?"
>
> "One hundred and sixty thousand."
>
> I then added, "And do you have experience owning a large apartment complex?"
>
> She replied, "No, but I'm not concerned about that. I do own a home we rent out."
>
> "I'm sorry," I told her, "you are just not qualified. Why don't you buy something you can afford and have the experience to run, like a fourplex?"
>
> "You don't need to insult me," she answered, "Riverwalk is what I am looking for."
>
> I went on, "I'm certainly not trying to insult you. It's just that you only have about two percent to put down and no experience."
>
> Kelly very proudly told me, "That's not going to be a problem. I can find investors."

You would think that would be the end of it. Not at all. Kelly Fabros is the most determined and focused beginning commercial property investor I have ever worked with to this day. Her confidence and determination are unyielding. Through the course she had taken she had learned that if she found the right property for the right price she could raise investors to muster up the down payment, and that is exactly what she did. She brought in a high-powered executive from Intel, her parents, and a few other investors and had the down payment. Now she had my attention. I gave her an extensive due diligence list and she knocked off 100% of it enthusiastically. After crunching the numbers together, I told her that the property would not cash flow the 75% loan she wanted and that she would have to negotiate the price down to $6.3 million. "Okay, not a problem," she told me. And she did it. Kelly repeated this recipe many more times and did indeed become a millionaire.

I have come to recognize what I call the "Kelly factor" in other commercial property investors.

They just do not know they cannot do something that to others is so obviously out of their league. They don't have those thoughts of "Oh, no, what have I gotten myself into? What if everyone can tell that I'm just winging it?" Or "This is so much more than I can handle, I've had enough!" Instead, they see every roadblock as a challenge to find a solution for it. And then they knock down those roadblocks. If they don't know something, they learn what they need to know. If they don't have the down payment, their enthusiasm is so contagious that they have investors lining up to join them!

2. Can You Make the Right Choices at the Beginning?

Are you good at making choices at the beginning, or are you a wanderer? You really have two choices: is it more you to be proactive or reactive? As a buyer, are you more prone to start out knowing what you want and be in charge of finding a property that meets those objectives? Do you have the willpower to not detour much from those goals? Or is it more you to go with the flow—to start out in a direction that seems interesting and then veer from it because something completely different catches your eye?

For my client Janet, finding the right commercial property reminded her a lot of online dating. She had sold four rental homes and wanted to get into commercial property. She found a 24-unit apartment complex in her hometown of Syracuse, New York, offered at a 7% *cap rate*. This made it a good buy since properties of this quality were going for closer to a 6.5% cap. She thought that maybe she would do some cosmetic work on it, raise the rents, increase the value, and flip it. It started out with "Hey, I like your pics, let's meet up." Which led to "Thank goodness I didn't waste my time on that one—it has too many problems." And then her real estate broker showed her a small strip mall that had really good looks and a great upside—under-market rents. Janet hadn't thought of retail but got the feeling that this property just might have chemistry. The meetup went well. But then she looked at the rent roll. The tenants were indeed paying under-market rent, but it concerned her that most of the leases did not mature for two to three years. The realtor explained that this was why he had chosen the property for her: "It is such a good buy." She replied, "So, the property is overpriced now, but in two years it will be worth it?" When Janet finally got the financials the net operating income (NOI) did not match up with the cap rate. Now she was really mad because she felt she had been lied to.

So a friend told her that she really should try self-storage. She went on LoopNet—the largest online commercial property listing service in the United States. Janet found a self-storage facility in Chattanooga, Tennessee, offered at a 9% cap. During the flight over to see the property she was filled with excitement. On the ground, this turned to confusion when the listing agent told her that the current owners were managing it and living on-site and that there was a nice apartment for her to live in while she ran the business. Janet's intention was certainly not to move to Chattanooga and buy herself a job. And if she paid the estimated $24,000 per year to have someone else live there and manage the property, she would be buying it at a 6% cap and the property would be vastly overpriced. The listing agent had a remedy—a great price on a single-tenant property in town. The tenant was a day care center. Janet thought, okay, maybe this is the one.

Successful, proactive commercial property investors know who they are, what they are looking for, and where they are looking for it. They know exactly what their financial objectives are for the short term and the long term. These investors have a plan and they do not deviate much from it. It would not occur to them to see which way the wind blew that day and drift in that direction like Janet did. They are willing to look at dozens of properties to find the one that fits their plan. Proactive investors also know what type of commercial property fits their lifestyle and become experts in that type. These self-directed individuals know where they want to buy and whether they would be comfortable moving for a property that needs hands-on management. They know their minimum acceptable return on investment and maximum risk level and they stay within their comfort zone on both. Very importantly, they know if they can live with having partners or whether this will drive them crazy.

Proactive investors know whether they are looking for an opportunistic investment or a solid, stable one. They know what size market is best for them—*primary*, *secondary*, *tertiary*, or *very small* (see Encyclopedia Topic H, Financing). These investors know what their competition is and what they can do to outdo it. They have a budget for repairs and financing costs, and they stay with that. They likely already have a team together—the best real estate brokers, investors, general contractors, lenders, property managers, insurance agents, and attorneys. These entrepreneurs are able to see value-add strategies for a property that everyone else has missed. They only employ the most cost-effective ones and know how to estimate costs for these accurately (see Chapter 7 on repositioning). Most importantly, they only buy properties that fit most of their objectives. And the ones that don't—well, they just walk away (see *buyer's list of property objectives* in Encyclopedia Topic A, Buying).

3. Can You Walk Away—Even if You Are in Love with the Property?

This might seem like a no-brainer, but you would be surprised how often buyers find themselves falling head over heels for a property and then paying too much for it. In a seller's market, sometimes buyers are just tired of looking and settle for less than they should. First impressions can really get you in trouble.

My client Craig knew right away that he'd found the light-industrial complex he was looking for. All the signs told him that it was the right property. He told me, "There is so much synchronicity. The sellers have been so forthright in providing me with everything I asked for. I really hit it off with them over lunch and they were so transparent on sharing some repair items." But after investing a great deal of time in due diligence, the property was just not meeting his financial objectives. His realtor arranged a meeting with the listing agent and the sellers. Craig planned to show the sellers on paper that their numbers did not work at the price they were asking. The meeting did not go well—the sellers wouldn't budge. Craig's broker told him, "They know you want it—you should not have had lunch with them." Craig started thinking that he could make their price work that he could recover the loss over time by adding value and raising rents. Fortunately he woke up the next morning and decided to walk away.

Buying the property for the right price is the single best action that you can take right out of the gate to increase your cash on cash return. A few years ago one of my borrowers fell madly in love with a brand new 64-unit apartment complex, which I'm sure was the nicest in Utah. It certainly was the most expensive. I could see why. It was breathtakingly beautiful, with granite countertops, Karastan carpets, and magnificent river views from every room. I told the borrower, "John, do you realize based on current cap rates and comparable sales on A Class multifamily that this property is only worth about 13 million and you have just offered 14.5 million for it?" "I don't care," he replied. "Terry, you have to help me get it." I argued, "It's not like you are going to be living there, and your friends will never likely see it. Find something that is priced below replacement costs like the last property you bought." "No," he replied. "I want this one!" Two months later we closed on the deal. That was after we showed the 13-million-dollar appraisal to the seller and he dropped the price by half a million. John still paid a million dollars more than it was worth.

It takes so much time and money to raise the net income of a commercial property compared to the time it takes to buy one for the right price. Just think about what John will have to do to make up the million dollars he overpaid. The property was new and did not need anything. Plus it was well managed and few, if any, expenses could be cut. That leaves raising rents, which were already at market. Let's say he could raise the rent of all 64 units by $100 per month. It would take 13 years for those rent increases to add up to a million dollars.

The bottom line is that no one starts out shopping for a commercial property with the objective of paying more than a property is worth. This only happens when there is an emotional attachment to a property for sale. Many of my clients have found a property with good looks and absolutely had to have it at first. But after doing their due diligence and recognizing that it was overpriced, most woke up and told themselves, "No, this doesn't fit my financial objectives. I'm going to pass on it."

4. Are You Willing to Become an Expert in a Commercial Property Type?

Thirty years ago my client Roger Allen, a professor in real estate and finance at Boise State University, kind of fell into the self-storage business. A student came to him with the idea of building a bunch of small garages on a vacant piece of land. He asked the youngster what in the world did he want to do that for and how he expected to do it if he did not have any money. Roger ended up financing the project and found himself in the self-storage business. Today he has 15 facilities and over 15,000 units. I told him that he had the equivalent of a doctorate in self-storage. Building a self-storage property from the ground up is one of the more risky commercial real estate investments. This is because there is usually a lot of competition and these properties take a lot of time to reach stabilized occupancy. But because Roger knows exactly how to evaluate the need for them, how to market them, and how to manage them, the risk is very low for him.

Lenders prefer to make loans to those who have experience in that property type. Many top-producing commercial real estate brokers specialize in just one type of property. CBRE Group will not allow its brokers to specialize in more than one type. Why? For exactly the same reason you do not find a physician who specializes in both radiology and orthopedics. Most types of commercial real estate really are that specialized. Yes, all types do have many of the same analytical components, such as rent rolls, operating expenses, and NOI—and let's not forget capitalization rates. But that's where the similarities end. Understanding how to lease and handle tenant improvements for an office property is very different from leasing and managing an industrial complex. So if banks and real estate agents have discovered that one can be more successful by specializing in one type of commercial property, does it not make sense for buyers of commercial real estate to do the same? It's not to say that once you master the quirks of one property type you cannot succeed at another. The point here is that when you get good at something and have mastered the learning curve, you can duplicate this repeatedly, saving time and money.

5. Are You Willing to Buy in Your Own Backyard?

Buying in your own backyard means being able to drive to the property you are interested in purchasing within an hour. If it takes much longer than that, you are just not as likely to check on the property very often.

It is interesting that Fannie Mae is reluctant to make a loan to would-be apartment building buyers if the property is in a state other than the one in which the borrower lives. During the Great Recession, almost all of Fannie's defaults came from this sector. Just about all the commercial property failures in my commercial finance business were from out-of-state borrowers too. So unless you visit the property often and have a hands-on approach to your out-of-the-area property, you could be quadrupling the risk of losing the property. When the property is in your own backyard, you can make surprise visits. You will know when the parking lot has trash on it, or if the lawn is turning brown. When you own a property locally you will be able to oversee leasing and maintenance at a level that just cannot be matched in a property that is far away. Just being able to drive by the property often and getting to know your tenants will give you a competitive advantage.

One of the main problems of buying out of state is that it can be difficult to know and understand the market you are buying in. A commercial property in another state that might appear to be a good buy if it were located in your backyard may be overpriced where it is. Also, it's always better to buy where your trusted team of professionals is expert, in a market you already know and live near. We are talking about your buyer's real estate broker, your local lender or commercial mortgage broker, your property manager, and your commercial real estate attorney.

I am an expert in many of the markets I lend in. But as a commercial mortgage banker who lends in all 50 states, I am at a disadvantage in that I just cannot have current, cutting-edge knowledge of all the markets we lend in. Often I have to rely on professionals who live and work in those markets or research companies for the data I need to evaluate a property and the competition. I think you will find yourself in the same situation if you purchase property in a market you are not familiar with. Most of my large commercial investors who own over $20 million in real estate invest in their own market first.

If you live in a very expensive area, such as San Francisco where commercial properties sell below a 5% cap, you can be handsomely rewarded for investing in a lower-priced, higher-cap-rate market such as Dallas, Texas, where you can still find quality commercial properties at an 8% cap. The majority of my California clients buy out of state. However, they know that they have to have excellent management and visit the property often to pull this off.

6. Do You Know What Value-Add Strategies You Ideally Want?

Mike Warren, the founder of AMJ Inc. in Gainesville, Florida, has purchased and repositioned over $400 million in commercial real estate. When he first looks at a property, he immediately starts looking for value-add strategies. He does this by what he calls "undoing restraints," or determining what can be done to undo a constraint that somebody else didn't find or could not act on. Mike knows that if he buys a property and does not improve it that it will not go up much in value. Constraints can involve regulations, zoning changes, or making physical changes that can attract better-quality, higher-paying tenants.

Many of my clients get an intuitive rush of value-add ideas when they first find a property. And some even lie awake at night thinking about them. For some, this is the part of buying commercial real estate that is the most fun. Do you know your value-add strategies at the beginning? The least costly ones are operational and involve improving management: raising rents and lowering expenses. Cosmetic changes, like a new coat of paint or striping the parking lot, are moderately expensive. And construction changes, like replacing a roof or adding on more square footage, are very expensive. Go to Chapter 7 for much more detail on this subject.

Time and Money Saving Tip

Wouldn't it be much better to have the best value-add deals find you instead of you having to pound the pavement to find them? Just follow this recipe that one of my most successful real estate investors uses. Put it out to 10 or more real estate professionals (real estate brokers, commercial loan brokers, commercial property managers, and bankers) that you have the wherewithal to close on a specific type and size of commercial property. Let them all know that you will use them if they find you a deal. Tell them you are looking for a distressed seller who is motivated by bankruptcy, recession, divorce, bad health, death, or rehabilitation projects that have gone wrong. Then just relax and wait for the phone to ring.

7. Do You Know Your Acceptable Risk Level?

As already mentioned, the most important question to ask when buying commercial real estate is "Who are you?" The second most important question is probably: "Is it worth it to take these risks for the expected return on this investment?

The real estate market has always gone up and down in cycles and always will. Boom periods can last from two to 10 years and are followed by recessions that can last from eight months to a year and a half. In the summer of 2007, many commercial real estate investors didn't know they were buying at the top of the market, as prices had continually gone up over a six-year bull market. By December of that year, the Great Recession was building momentum and prices started tumbling. This occurred on a bigger scale when in January of 2020 most investors, real estate brokers, and lenders of commercial real estate were preparing for another good year. After 10 years of a continual up market with property values soaring, most seemed to forget that recessions even existed.

Two months later, the United States and most of the world found itself freefalling into the coronavirus recession that history will likely remember along the lines of the Great Depression of 1929. During the seven-week period from March 26 through May 7, 2020, 33 million workers applied for unemployment benefits, raising the rate from 3.5% to 14.7%, according to the Bureau of Labor Statistics. Many of these workers could not pay their rent and their bosses could not pay theirs, either.

The coronavirus recession might be a one in a hundred-year event. No one knows for sure. The silver lining for commercial real estate buyers is that recessions turn seller's markets into buyer's markets and bring prices down, which brings up the question, "How do you know if prices have hit the bottom and you are getting the best price?" Sorry—you won't know where the bottom is until prices start going up again. So when is the best time to buy? Read on.

FOUR PHASES OF THE COMMERCIAL REAL ESTATE MARKET CYCLE AND THE BEST TIME TO BUY

One of the most important factors in determining risk is to be aware of what phase in the real estate market cycle you are buying in. Unless you are the best psychic on the planet, you will not be able to determine how long a cycle will last, but you can learn to identify which cycle you are in and implement a safer, more informed investment strategy for that cycle. For example, if you want to purchase a property to reposition it, the last thing you want to do is to buy a property that needs expensive cosmetic and constructional changes if the market is in the hyper-supply phase where prices are at their peak, because you would likely be overimproving the property for its potential future value. Even if you find a property with under-market rents in this cycle, you could be in trouble if you pay top dollar for it. If your goal is to improve a property, raise rents, increase the value, and sell at a profit, it makes sense for you to buy during the recovery phase, when prices have hit bottom, and wait until the market is deep into the expansion phase to sell. Here are the four phases of the real estate market:

1. *Recovery*. Preceded by the recession phase, the recovery phase can be identified when unemployment has gone down for two consecutive months, commercial lenders are doing ground-up construction again, and vacancies and declining rental rates have plateaued. The beginning of this phase is the bottom of the market, partly because there has been a year or more of lower sales comparables to bring appraised values down considerably. Prices will gradually be going up now as the economy recovers. This is the very best time to buy, as distressed sellers have faced the reality of where market prices are. Foreclosures have now reached their peak, resulting in many opportunities to buy properties at public auctions and bank owned properties. Seller financing is much more available. Because prices are at their lowest, this is the best time to buy commercial properties that need little work for a good price.
2. *Expansion*. In this phase, the market has recovered: job growth is good, GDP is back to normal, and occupancy and rental rates are going up. There is increasing competition for properties for sale and prices are rising. This is a good time to buy properties that need repositioning with value-add strategies, and financing is more easily attainable again. At the beginning of this phase, prices are set fairly for both buyers and sellers, where neither really have an advantage. This is still a decent time to buy, as sellers are reasonable. At the middle of this phase, it becomes a seller's market; cap rates have been continually coming down, prices are going up, and rental rates and occupancy remain high. New construction starts are shooting up and bare land is being purchased at insane prices for future development. You can tell this is not the best time to buy.
3. *Hyper-supply*. In this phase, there are too many units on the market as a result of the completion of too many construction and rehab projects; the market has too much supply. This causes construction to slow, rental rates to come down, and rental concessions to increase. Surprisingly, a seller's market with high prices can hang on for a long time during this phase. What is truly amazing is how long buyers keep buying at the top of the market. As you already know, this is the worst time to buy.

4. *Recession*. The coronavirus recession was an anomaly caused by a pandemic. But most recessions are the result of out-of-control growth and unrealistically high prices. GDP and rental demand go down, jobs are lost, rent and mortgage defaults increase, and new construction stops. At first, purchases almost stop, as no one knows what properties are worth; financing choices diminish and loan guidelines become stringent, resulting in many buyers no longer being able to qualify for a loan. At first, sellers try to ride it out, hoping to still get good prices. Strange, but it will take about seven months for many to face reality. By then, there will be enough low sales comparables to reduce appraised values. Distressed sellers will no longer be able to hang on, as their NOIs have dropped below their *break-even ratio* (Encyclopedia Topic A, Buying), having pushed many into foreclosure. Their properties will be sold at a big discount. This is a great time to buy. And it is the very best time to buy a property that was purchased during the hyper-supply phase for rehabbing and the owners have crashed and burned, not completing the renovations, the lease-up, or both. Boy, can you snatch a property like that up for a good price.

Time and Money Saving Tip

Would you like to learn how to buy commercial properties that have been foreclosed upon on the steps of the county courthouse? You will want to get some experience with the auction process first by going to many auctions. The best time to buy is when the recession phase of the real estate market turns into the recovery phase. This is when banks have failed at selling many nonperforming notes at a discount and the most foreclosures are in their final stage. You won't know ahead of time what the bank's opening bid will be; the auctioneer will mention this when the auction starts. So look up the deed online at the county recorder of deeds' office, and find out what the original mortgage amount was. Then estimate what the principal balance might have been reduced to. The bank will want to recover that amount plus back taxes, attorney fees, and court costs, and this total will most likely reflect the opening bid price. You will need to know ahead of time what your maximum bid will be. For more on this, go to *auctions—buying at* (Encyclopedia Topic A, Buying).

THE LOWEST-RISK PROPERTY TYPES TO CHOOSE

The type of property you choose to invest in is likely the largest determination of its risk level. Face it, people need a roof over their heads during the best and worst economic times. In fact, during a recession, many lose their homes and are forced into the rental market; this puts apartment buildings at a much lower risk than strip malls, as far as occupancy goes. But then during a recession, Class C-minus multifamily properties in blue-collar neighborhoods are rampant with slow-paying and nonpaying tenants who have lost their jobs, putting the properties at a higher level of risk for poor rent collections than a strip mall, where the tenants have the survival of their business at stake. Surprisingly, Class C-minus apartments are still ranked at a lower risk level than a retail center, because they can bring in new tenants in a matter of weeks, whereas for a retail space it takes an average of seven months to find a tenant, negotiate a lease, and have tenant improvements completed.

I have listed the major commercial property types below in the order of their level of risk during a recession for retaining good occupancy, rent pricing, and collections, with number one being the lowest risk. This is based on my experience lending on and evaluating financials for these property types during all economic cycles and the past three recessions, starting in 2001, as well as on risk assessment analysis for commercial lenders extrapolated from Moody's Analytics.

1. *National credit tenant triple net lease property* **(extremely low risk)**.Tenants of these properties have a credit rating of single A (A) to triple A (AAA) and 15 years or more remaining on the lease. These bulletproof properties are very expensive, with a low rate of return on investment. A property leased to the Home Depot, which has an A+ credit rating on a 25-year lease, has almost zero risk. A building rented to Walmart, which has an even higher credit rating of AA, has an even lower risk. Your chance of getting struck by lightning right now while reading this book is higher than the odds of Walmart missing a lease payment. The downside is that these properties are being sold at a 4% cap, which means that without a mortgage you would be earning 4% annually on your investment.
2. *Class A and B multifamily lifestyle properties* **(very low risk)**. These properties attract more affluent tenants that have good incomes, and, better yet, most have savings and pay their rent during a recession. Some large cities ended up with too many top-of-the-line apartment complexes during the coronavirus recession and had to reduce rents to fill them.
3. *Mobile home parks* **(low risk).** The majority of the mobile homes are owned by the tenants, not the park. These homeowners have a pride of ownership and keep their homes and yards in tip-top shape. Even during hard financial times, these renters seldom skip their rent; if they do, after a few months the park owner can slap a lien on their home and put a for sale sign on it.
4. *Senior housing* **(low risk)**. 55 and older properties and independent senior living facilities are best in this category. These tenants have retirement income,

which is often more reliable than a job. Assisted care, memory care, and nursing homes are a much higher risk, as they require skilled nursing and very specialized management.

5. *Class C+ multifamily* **(low risk)**. These properties are older apartment complexes in great shape, located in good neighborhoods, with much lower rents than the Class A and B properties. During a recession, they stay full with tenants who pay the rent.
6. *Medical office* **(low risk)**. These properties include physician, medical clinic, outpatient surgery, physical therapy, and lab offices. They represent the safest investment in office properties with the highest rents. As our population ages, medical care is always in demand. Dental offices do not fare as well during recessions, as if dental work can be put off if there is no pain. The downside to medical offices is that when leases run out and are not renewed, the tenant improvements are very specialized and require a complete retrofit for other types of office tenants. Medical office buildings located near hospitals always seem to stay full.
7. *Flex industrial property* **(low risk)**. Made up of smaller spaces with affordable rent, these properties are occupied by business tenants that take pride in taking care of their shops. Each space has manufacturing and/or storage on one side and a sales office on the other. Tenants faithfully pay the rent and these properties tend to stay 100% full. Tenants know that their spaces are in high demand and do not want to risk losing them.
8. *Student housing* **(moderately low risk)**. Student housing overall did well during the Great Recession, as college enrollment went up significantly and student loans were in abundant supply. These properties have a much higher risk if the majority of leases are for the nine-month school year, giving the property low economic occupancy. To remedy this, make sure all tenants sign a year-long lease guaranteed by their parents.
9. *Self-storage facilities* **(moderately low risk)**. Ideally, find a facility that has an occupancy of 85% or more with under-market rents, as vacancies can be slow to fill and you need to remain competitive. This property type runs amazingly low expenses, resulting in one of the lowest occupancy break-even points of all commercial properties. Often all the expenses and the mortgage can be paid at 60% occupancy. Self-storage is in demand during both good and bad economic times. The downside is the risk of a new competitor locating near you; they will undercut your rents, forcing you to lower them.
10. *Class C and C-minus multifamily* **(moderate risk)**. These properties certainly do stay full during recessions, but, as mentioned earlier, rent collection problems resulting from tenants' losing their jobs make them a higher risk. During

a financial crisis, without hands-on management these properties can have a high failure rate.

11. *Mixed-use buildings* **(moderate risk)**. These can be Class A and B or C properties with mostly multifamily tenants, but have a substantially higher risk if they average 25% or more office or retail on the first floor. What makes mixed-use properties a moderately high risk is the potential for all the office and retail tenants to move out during a recession, making it difficult for the property to break even. To lower this risk, put in commercial tenants that do well during a recession, such as a utility company office, government office, urgent care, or thrift store.
12. *Retail centers* **(moderately high risk)**. Strip malls can be a risky investment and have gotten hit especially hard during the coronavirus recession. But with an experienced manager and the right tenant mix, they can still be a good investment. Buying at the right price and at lower leverage, where the property can run profitably at 70% occupancy, can make this property type recession-proof. Every year it seems that more people are buying more retail items on the Internet, so be sure to mix in businesses like restaurants, hair salons, and other services that will be largely unaffected by the shift to purchasing items online.
13. *Office properties* **(very high risk)**. Multitenant office buildings did not fare well during the Great Recession but recovered with time. They really bombed during the coronavirus recession, which has resulted in an oversupply of space as many business owners have discovered that they can save by having more employees work at home.
14. *Hospitality* **(very high risk)**. Hotels and motels took a dive during the Great Recession and then amazingly sprang back to peak performance. But it is predicted that it will take a long time for the hospitality industry to rebound after the coronavirus recession. Many of these properties will make great repurposing opportunities, as they can be converted to apartments and student housing.

TEN RISK-LOWERING ACTION STEPS

The third most important question to answer when buying a commercial property has to do with your mental health, or "What can I do to lower my risks when buying so I don't have to lay awake at night worrying about it?" Implementing as many of the following risk-lowering action steps as you can will take a load off your mind.

1. *Choose a property closer to home*. Yes, we have already discussed this earlier in this chapter, but I do want to emphasize again that one of the highest risks is buying far away from home. If a recession hits and your occupancy and rents

drop, you are going to need a hands-on approach, even if you have professional property management. How will you know if the on-site manager is not showing up to rent units on weekends, the lawn is dying, or the parking lot is strewn with garbage? If you can't drive by the property often, you won't know. If income really drops, you can let go of your property manager and handle the leasing and some maintenance and repairs yourself—but you can't do this if you have to get on a plane or drive four hours to get to the property.

2. *Choose a property that retains its tenants*. Multifamily properties that have many tenants who have lived there for three years or longer have a tendency to stay full during tough economic times. These tenants have an attachment to their homes and do not want to lose them. Retail, office, and industrial tenants who have occupied their space for five to 10 years or longer have proven their stability. Most will be stronger, more established businesses that have cash in the bank and lines of credit to make it through a recession.
3. *Choose a property with good historical financials*. You wouldn't want to buy a manufacturing business that had only six months of financials. Buying a commercial investment property that doesn't have a track record amounts to the same thing. A property that has always run strongly in the black is more likely to make it through a recession. You want to collect four years of month-by-month income and expense statements, looking for consistent good NOI. Conversely, fix and flip and unstabilized properties that are totally relying on projections are the highest risks, unless you have experience.
4. *Choose a property where you can negotiate a purchase price based on economic occupancy*. In a seller's market, never pay full price for a property based on a full rent roll when some tenants are paying late or not paying at all. Come on, if only 78% of the tenants are actually paying rent, then the property is worth a lot less. Many sellers and their listing agents are sneaky, and will try and sell the property based on physical occupancy. To accurately determine economic occupancy, you will need to do a *collections verification report* (Encyclopedia Topic B, Due Diligence). What a great repositioning opportunity at the right price!
5. *Choose a property in a large or medium-size market*. Large cities have more industry, job opportunities, and a more diverse economy; these factors will help in surviving a recession. Buying a property in a small town that lacks major industry close by and has few jobs is risky. Buying in a low-income, high-crime neighborhood is even riskier.
6. *Choose a property in which you have walked every unit or space*. Even if you get a property condition report, there is nothing that can equal walking every square foot of the property before you buy it. If you take a contractor with you, all the better. Believe me, you will find things that the property inspector has missed.

The buck stops with you when knowing the condition of the property you are buying and walking the property yourself greatly lowers your risk.

7. *Choose a property with good occupancy and leases*. Buying a property that is already at or above market occupancy and full of high-quality paying tenants on long-term leases is the safest scenario. Buying one that has low occupancy with many lease terms ending soon, or one that cannot cash-flow expenses, is risky.
8. *Judge the cost and time for repositioning a property correctly*. Whether you are making inexpensive operational changes or more costly cosmetic and construction ones, misjudging the cost and time needed to complete the project and fill it with tenants can cause you to lose the property.
9. *Know the market*. This mean knowing you are not paying too much for a property based on comparable rents and sales prices in the submarket. If you are planning on repositioning the property, raising rents too high, resulting in low occupancy, or overimproving a property for the neighborhood and its potential value are signs that the buyer did not study the market and the competition. This creates a high-risk investment.
10. *Factor in all the costs correctly*. We are talking about unexpected expenses right before or after closing such as repairs, a more expensive loan than planned on, and, most common, unexpected closing costs like tax and insurance impound escrow accounts and payment of interest in advance on your new loan. Not factoring in these costs will result in your having a lower return on your cash invested and, worse, less post-closing cash for your rainy day fund.

FOUR LEVELS OF RISK BASED ON PROPERTY CONDITION, INCOME, LOCATION, AND OCCUPANCY

1. *Core deals*. These properties have the lowest risk. They are in great condition; are in a good location; have very established, quality tenants; have strong historical incomes; and are fully leased. These properties are the most expensive. You should choose these properties if you want the lowest risk and can afford them.
2. *Core plus deals*. These properties have a higher risk due to the property needing some work, being in a less favorable location, having less-than-stellar historical incomes, having tenants that are of mixed quality, and having lower-than-market occupancy. These are usually Class C properties that are moderately priced. If you find one in a good neighborhood and can give it good management, the risk can be low.

3. *Value-add deals*. These properties have substantial risk just because you are making many untested changes to the property to increase net income and value. These properties need repositioning to achieve their potential. The likelihood for cost overruns and lengthy delays in completing the improvements and reaching market occupancy means these projects have substantial risk. They might not cash flow now, but with some cosmetic work or light rehab rents can be increased. The only way to lower the risk is experience. If you do not have it, bring in an investor that does.
4. *Opportunistic deals*. These properties have the highest risk, and include those that require major rehabbing or ground-up construction. The greatest risk lies in underestimating the time it will take to build and stabilize (fill to market occupancy) the property. These deals usually have no income for a year or longer, which makes them very risky. Experience is a must. Chapter 11 covers all the steps involved.

"*The Encyclopedia of Commercial Real Estate Advice* is a serious, bottom-line book about making and modeling sound business decisions around buying and selling a commercial property. It covers raising money from investors, due diligence (most important in my opinion), developing from the ground up, repositioning a property to its highest and best use (my personal favorite), leasing and management, and of course, financing. It's probably the most useful advanced real estate book I have ever read."

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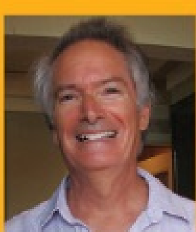

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