

# COMMERCIAL REACH



## Investing In Commercial Properties

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# Investing In Commercial Properties

If you are dead serious about growing and expanding your real estate business as a real estate investor, real estate broker/agent or both, then please keep reading. If you struggle with making decisions in your life, particularly when it comes to business and/or finance, then stop now.

The following is a general but thorough explanation of real estate investing in the commercial world. When you operate in the commercial world you have to be able to be decisive. Otherwise you will waste your time... and other people's time and effort... and they will not give you a second chance.

Generally speaking, commercial agents/brokers are not going to roll out the red carpet for you if you are also a broker/agent. In other words you better know what you're doing.

This next section is a great way to familiarize yourself with some of the terminology and methods used in the commercial world. Then you and I can work together to take some meaningful effective action and get some results under your belt so you can really build your empire based on financial and intellectual strength.

This is the level that most real estate investors aspire to. It is where very large fortunes can be made. Are you with me? Are you ready to play with the big boys? Good. Let's get started.

Much of the following material is courtesy of classes I have taken in commercial real estate over the years with my own experiences provided to lend context.

Generally, the commercial investment brokerage business is divided into activities, which deal with either users or investors. If one considers that real estate is only a square foot of space that must be used by someone, there are two uses for the property.

This first one is looking at the business of the users, on the property. Example, fast food franchises look at the spaces which they are occupying as places where business is conducted. Whether the franchisees are tenants or owners of the space, they look at the space as a place to sell food. The cost of occupying the space is a cost of doing business

#### COMMERCIAL PROPERTIES

as providers of food products. All things being equal, tenants prefer properties with the lowest cost of occupancy.

While the income source to the users above is the sale of food, investors have a different view in the use of a square foot of real estate. Investors are in the business of selling; they're looking for the use of that square foot to others who can use the square feet in their businesses. Investors are interested in the income the properties can produce; they use the rental of the square feet as a base, calculating the possible income stream of the property. Essentially, investors prefer properties with the highest income streams.

Whether agents are working in the user or the investor part of the industry, there are specific activities in which they might become involved. Let's have a look at them.

#### Agent Activities

##### User Brokerage

- ❑ Leasing
- ❑ Landlord Representation
- ❑ Tenant Representation

##### Investor Brokerage

- ❑ Sales
- ❑ Seller Representation
- ❑ Buyer Representation
- ❑ Development
- ❑ Site Selection

- ❑ Construction
- ❑ Financing
- ❑ Loan Brokerage
- ❑ Mortgage Banking

### User brokerage

The most common activity in which agents might participate is bringing together tenants and landlords in transactions. Most users choose to control and occupy property through a lease. At the same time, brokers or agents must be mindful of the motivations and needs of the investor and the motivations and needs of tenants, too, such as what their intent is for the property.

Over the years I have managed thousands of tenants in hundreds of units for dozens of owners. And I made a ton of money in the process! I made money at least a dozen different ways. Of course I also collected a management fee every month, and a leasing fee every time I leased a vacant unit. I collected lease application fees, lease renewal fees, late fees, and nuisance call fees. I collected extra fees for pets and smokers. I charged a 10% override for maintenance and repairs to the owners and to the contractors performing the work. I also collected sales commissions every time an owner bought or sold a property.

Property management provides one of the best lead sources you will ever have. Every time a prospective tenant applies to rent one of your units you get current and prior landlord information. Once you screen the prospective tenant you can then offer your services to the current and prior landlords! And you get paid an application fee to get this contact information! On top of that you have contact information for attorneys, insurance company reps, contractors like roofers, electricians, plumbers, carpenters, flooring installers, locksmiths, municipality employees (including zoning and occupancy officers), utility companies, appraisers, title reps. The list goes on and on and you can reach out to all of these people and offer your services! Hallelujah! Come to Papa!

Let's break this down into the major roles.

## LEASING

Landlord Representation and Tenant Representation were both covered under the "Investor-Agent, Make More Money Not More Work" section of this book.

### Investor Brokerage

This is another area where I have made a ton of money. It started out small. When I first got my license I used it only for myself in my own investing activities. I slowly started using my license to generate commissions by representing other investors in their investing activities. Then I built an independent brokerage company named Win Realty Advisors. I was able to leverage these investor relationships to generate additional income by offering property management services, title services, and appraisal services. In the meantime however, I generated a lot of commissions from the inherent repeat business I got from investors.

### Duties of an Agent in an Investor Brokerage

The most common brokerage activity is bringing together buyers and sellers in a transaction. Stockbrokers, food brokers, and commodity brokers provide all the same functions as real estate brokers. Although brokers do not have any ownership in the

#### COMMERCIAL PROPERTIES

properties, they are generally compensated on a commission basis and collect a fee based on a percentage of the transactions.

#### SALES

Seller Representation and Buyer Representation were both covered under the “Investor-Agent, Make More Money Not More Work” section of this book.

#### Development of Commercial and Investment Brokerage

Many commercial investment real estate agents become involved with creating a product through the development process. There are many different activities in the development part of commercial and investment brokerage.

#### Construction

Commercial investment real estate agents may be involved in the construction phase of a property under development.

#### Financing

Commercial investment real estate agents could arrange the financing for a property to be built.

#### Site Selection

Commercial investment real estate agents may be involved with users and investors of properties in selecting sites. This helps a property owner to determine the best location for the next development.

#### REQUIREMENTS RELATING TO ACTIVITIES IN MORTGAGE

#### BROKERAGE

Each state's individual real estate laws have specific requirements relating to activities in mortgage brokerage. Generally, mortgage brokerage activities can be conducted by real estate licensees who also have a mortgage brokerage license. Certain federal laws, such as the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act), regulate the activities of brokers, when involved with loans made on residential properties.

### Brokerage

This allows commercial investment real estate agents to concentrate on brokering mortgage financing by representing borrowers who are looking for financing.

### Mortgage Banking

This allows commercial investment real estate agents to be involved in mortgage financing by representing institutional lenders who have funds to place in real estate.

In either activity, agents should have knowledge of the financial characteristics of the properties, because a property's ability to be financed depends on the income the property produces.

### Real Estate Agents Could Also Be Investors

From this section, you should understand right now we are talking about commercial investment real estate agents. As an Investor-Agent you could (and I think should) become involved in owning commercial and investment real estate, through investment in direct ownership of real estate.

As an Investor-Agent you should be aware of the financial characteristics of the real estate. Cashflow is the main reason we invest. The cashflow depends on the effects of the law of supply and demand, the availability of financing, and the effects of income tax laws.

Many investors progress from an entry-level investment, into small residential properties, and finally to the most risky – raw land speculation. While continuing to advance in risk, some investors decide to invest in money, not property; this allows them to become involved in real estate as hard money lenders.

Each step in the progression includes more risk. As investors move up, there are fewer properties, tenants, lenders, buyers, and sellers. But the belief is, as the risk increases,

the expected returns must be larger. Most investors get to a level where they are comfortable and continue to do all their investing at that level.

The four major property types encountered by investors and real estate agents increase in complexity, while rising in risk. Residential properties are usually the least complicated. Office properties are the next most favored property. Retail and industrial properties are more complicated, with industrial properties being the most complicated – and purchased by fewer investors. However, there are cycles in the marketplace; at any time, real estate agents may notice one of the property types is more favored than the other property types.

## Market Analysis

Regardless of the property type, the agent or investor will typically use two types of data to complete their market analysis. There is information on the property's location, and then there is information regarding the specific property.

### Market data

Market data deals with people. Economic, demographic, and lifestyle data is used to help determine the demand for a property. Never thought that economics class would come in handy, did you? As a refresher course, the breakdown works like this:

Economic data refers to data regarding employment by industry. Employment is an important economic indicator, as changes in employment changes demand for real estate. In other words, more people, more buying. Simple, right?

Macroeconomics pertains to the study of the overall economy. The conditions of the national economy can have a direct effect on the local economy. The study of the local

economy would be called microeconomics. When industries and services experience a change in demand for their products and services, the area in which the industry is located will be affected.

In simpler terms, supply and demand of people is not enough; there are other factors you must consider. If you are an agent in Florida, then what would you take into consideration? The weather – hurricane season. This could affect where you purchase real estate, or if a buyer will decide to... well, buy.

## Employment data

Employment data is usually described in one of these ways:

- ❑ Workforce characteristics. This overlooks the workforce. It will take into account the percentage of employment, education levels, and skills of those employed.
- ❑ Type of employment. This is going to look at what type of employment is readily available, through the available data.
- ❑ Lifestyle Characteristics. Employment will obviously trickle down into the lifestyle. It will dictate the community identity, trends and values, and recreational opportunity. Why? Because employment dictates the amount of money for each person; if you have an abundant community of welders, then you will want to use provided data to configure their possible budget. If not, you may find little success.

## Recreational opportunities

The abundance, or lack, of recreational opportunities can affect the population size of a community and therefore the demand for real estate. For example, Aspen, Colorado, attracts many people for its recreational opportunities. Certainly, there are other areas of Colorado that have the same climate as Aspen, but it is the recreational opportunities that started, and still drive, the growth of the city and surrounding area.

## Intellectual and educational opportunity

Areas with colleges and universities promoting higher education may draw a more highly educated population, which may attract a certain population that attracts certain employers.

## Cultural trends and values

Certain communities become popular and attract people, following a particular trend. Laguna Beach, California, and Santa Fe, New Mexico, are known as artist communities, and they attract a population that has similar interests, and those people will pay higher prices to live in such a community.

## Community identity

Some communities have a distinct identity. Certain college towns attract people to live there, even after completing their education. Certain communities have developed an ethnic identity, and attract certain groups of people to live there.

## Psychographics

The study of lifestyle characteristics is called psychographics. These studies help businesses identify emerging trends, niche markets, and new opportunities. For example, the trend toward specialty coffees has caused the growth of several specialty coffee shops, such as Starbucks and Seattle's Best. Even McDonald's and Dunkin Donut, have started selling specialized coffees.

## Demographics

This objective data is comprised of facts and statistics about the local population. Most is collected by the U.S. Census Bureau. It describes the age, sex, income, home value, and whether the household owns or rents. This information is important, since it deals with the facts gathered during the census.

## Comparables

The study of individual properties within a market usually breaks down into studying comparable properties in four general ways:

- Building data. Each specific property type has a unique way of categorizing and communicating property details.
- Rental data. Investors are interested in the cashflow that properties produce through rents received. Each property can be looked at as a unique stream of rental income.
- Building services. Not all buildings of the same type offer the same services, such as parking, janitorial, air conditioning, technology, and heat and air conditioning.
- Community services. Each building is located in a community that has its own individual amenities such as nearby transportation, restaurants, shopping, and recreational opportunities.

## COMMON CLASSIFICATIONS OF RESIDENTIAL INVESTMENT

### PROPERTIES

1. Garden
2. Mid-Rise
3. High-Rise
4. Others

### Garden Apartments

Located in suburban or rural areas, garden apartments are generally one- and two-story properties. Most units can be accessed from the outside of the property, using an exterior stairway to gain access to the second-story apartments. Rarely do garden apartments have elevators. Most units have individual utility meters and individual air-conditioning units. The property usually has a central laundry facility, and it may have one or more swimming pools. With this information, who do you know that would be an ideal buyer for garden apartments?

#### Mid-Rise Apartments

Located in the suburbs, mid-rise properties generally run from four to nine stories, consisting of studio, one-bedroom, two-bedroom, and three-bedroom units. Most units are accessed from a central hallway, which might be serviced by an elevator. Elevators are a blessing, aren't they? Although the units have individual utility meters, the building might have central air conditioning. These properties often have parking structures, a central lobby area, and recreation facilities. With this knowledge, who do you know that would be an ideal buyer for this apartment?

#### High-Rise Apartments



In the major urban areas, where land is scarce and expensive, high-rise properties are built. They are usually studios, one-bedroom, two-bedroom, and three-bedroom units; all are accessed from the central hallway, which is serviced by an elevator.

Located in urban neighborhoods, these properties often take advantage of city skyline views, and offer their tenants proximity to employment, security, recreation, and other amenities. Knowing all this, who do you know that would be an ideal buyer for a highrise apartment?

### Other Types of Residential Properties

Lastly, there are other types of properties... the red-headed step-children of residential properties. Joking, just joking. There are many other types of residential properties though, including single-family, duplexes, triplexes, and four-units. These properties do not have professional management, often being managed directly by the owner of the property.

### LENDER CLASSIFICATIONS OF APARTMENT BUILDINGS

1. Class A: Newer, Institutional Grade
2. Class B: Older, Institutional Grade
3. Class C: Older, Declining Area
4. Class D: Older, Declining Area

Lenders have developed general classifications of apartment buildings, so they can communicate among themselves and other members of the industry, with some level of uniformity. The classifications are Class A, Class B, Class C, and Class D.

### IREM®

There is no sugarcoating this next part, so let's just jump right in. The Institute of Real Estate Management of the National Association of Realtors (IREM) prints an annual publication titled *Income/Expense Analysis: Conventional Apartments*. For this publication, IREM® gathers actual income and expense records of apartment owners throughout the country. Afterwards, they print summary information, which is used by property managers and owners; the property managers and owners can then measure the financial results of their properties against the IREM® data. Information about IREM® can be found at [www.irem.org](http://www.irem.org).

### Property and Ownership Characteristics

Office properties are those properties which typically provide space for service industries. These spaces can then be used for the manufacturing or retail functions of the economy.

Investors often move from residential income property ownership to ownership of office properties, because they want to reduce the amount of management activity. Office buildings have some characteristics of an apartment building, such as many tenants; but office tenants go home at night and on the weekends. In addition, the landlord-tenant relationship can be more businesslike than the relationship between apartment building owners and their tenants.

Office suites are relatively interchangeable. Generally tenants of office buildings choose properties based on location. Since much of America's business is being done by smaller private firms, the location requirements of the owners of the businesses are the most important factor. Owners of the businesses make their decisions based on the following:

- ② Their perceptions of the images of the buildings in comparison with their perceptions of their businesses. Appearance is everything, right?
- ② The ease of the commute to and from the business owners' homes.
- ② The location of the office buildings in relation to the geographic area where the business's clients are located. Once again, appearance is everything, right?
- ② Smaller office properties with one tenant, or a small number of tenants, are owned and managed by individual investors. Larger, multi-tenant properties are often owned by investment groups.

### High-Rise Office Buildings

First built in Chicago in the 1800s, for all you history-buffs, these buildings have multiple stories, and are primarily made of steel and concrete construction. The exteriors are likely to be of pre-cast concrete or glass. Most are located in the central business districts of major cities. Tenants are often large national or multinational firms (big-wigs), who need large amounts of space (to count money). They are concerned with the brand and image perceived by their employees and clients.



### Mid-Rise Office Buildings

These buildings may also have elevators, since they are often more than two stories high, and they are primarily of concrete construction. The height of the buildings, marketplace, and zoning restrictions limit the number of stories. These buildings can be found in central business districts and also in suburban areas. Tenants are often smaller national or regional firms (little-wigs), who occupy smaller amounts of space (still to count money) and do not demand the image of a high-rise building (hence, the little-wig).



### Low-Rise Office Buildings

Most of these buildings are made of wood, and are not more than two stories. They are designed to fit in with the neighborhood. They are almost always located in the suburbs, and these buildings offer tenants the opportunity to have an exterior entrance to their units. These are also in demand by tenants who do not want to get “lost” in the larger properties (I say, “Buy a GPS”). Tenants are often regional or local businesses (who, sadly, have nowigs); owners usually want to be located close to their homes and the businesses of their clients.

### CLASS A, B, OR C BUILDINGS

In addition to the classifications of high-rise, mid-rise, or garden buildings, office properties are classified as A, B, or C buildings. Class A buildings are generally less than 20 years old, built of high quality, have modern functions, and are maintained very well. Class B or C buildings are often older and less functional. This classification is highly subjective and market specific. A Class A building in downtown St. Louis, Missouri, will probably be different from a Class A building in Duluth, Minnesota.

### Office Building Measurement Guidelines

Office building efficiency is important to tenants. The term efficiency relates to the amount of space tenants must pay in relation to the space they occupy. Highly efficient buildings limit the amount of common area tenants pay for, and inefficient buildings force tenants to pay for common area.

Tenants talk about usable area in describing the space they occupy. Landlords talk about the rentable area, for which tenants must pay rent. When the usable square footage equals the rentable, buildings are highly efficient and landlords and tenants do not argue about this issue.

## Common Questions

Office tenants and landlords often argue over the amount of square footage the lease covers. Common questions regarding a specific lease are the following:

- Does the tenant pay rent on common areas such as hallways, bathrooms, and lobbies?

Answer: Yes, the landlord collects rent from the tenant based on the total area of the floor the tenant actually uses, which includes hallways and bathrooms.

- Does the space stop at the inside surface of the office wall, the middle of the office wall, or the outside surface of the office wall?

Answer: Generally, the office area is measured from the inside of permanent walls and the center core of temporary walls.

- Does the space stop at the inside surface of the windows, on the exterior wall of the office space, or the outside edge of the windows on the exterior wall?

Answer: Generally, the office area is measured from the inside of the permanent exterior wall.

# How Office Space Is Measured

As previously said, landlords and tenants have a built-in conflict when determining how much space tenants must pay rent upon. The common terms used by investors and tenants are usable square feet and rentable square feet.

To establish acceptable answers to the questions raised above, the Building Owners and Managers Association International (BOMA®) developed the Standard Method of Floor Measurement for Office Buildings (Standards). Information about BOMA® can be found at [www.boma.org](http://www.boma.org).

The BOMA® website has this description of the Standards:

Standard Method for Measuring Floor Area in Office Buildings

Order# 133-FMS96-489

Since 1915, the BOMA Standard has been the only floor measurement method for commercial real estate, which is approved by the American National Standards Institute (ANSI). This approval is a must for building owners, managers, facilities managers, tenants, appraisers, architects, leasing professionals, lending institutions, and others.

The revised Standard includes how to measure new tenant amenities and building features, such as spacious entrance lobbies, conference centers, health clubs, and daycare facilities. Generously illustrated with clear, easy-to-read diagrams, the Standard defines approaches to measure the following:

- Gross Building Area
- Gross Measured Area

- Building Rentable Area
- Floor Rentable Area
- Floor Usable Area
- Usable Area
- Floor Common Area
- Basic Rentable Area
- Building Common Area
- Rentable Area
- Office Area
- Store Area
- Overview and Global Summary sections help you apply the Standard quickly and easily. Start measuring your building a better way. Order the BOMA Standard today. BOMA International, 1996.
- Prior to the 1980s, common areas were generally restricted to the floor on which the tenants occupied their space.
- In the 1980s, office buildings started to be constructed with common areas, which served tenants of the entire building regardless of the floor, or floors, the tenants occupied.
- While a complete discussion of the Standards is beyond the scope of this book, knowledge of some common definitions needed by real estate agents is useful.

BOMA® Definitions:

Office Area: The area where a tenant normally houses personnel or furniture.

Usable Area: The measured office area.

Rentable Area: The usable area of an office area with its share of floor common area and building common area. Rentable area = usable area x R/U ratio.

## COMMERCIAL PROPERTIES

**Floor Common Area:** The areas on a floor, such as washrooms, janitor closets, electrical rooms, elevator lobbies and public corridors, which are available primarily for the use of tenants on that floor.

**Building Common Area:** These are the areas of the building that provide services to the building tenants, but are not included in the office area of any specific tenant.

**Dominant Portion:** Refers to the permanent outer wall of the building. Generally, if more than 50% of the surface of the outer wall is glass, then the glass becomes the dominant portion.

**R/U Ratio:** The conversion factor that, when applied to usable area, gives the amount of rentable area.

**Usable Area:** Generally the usable area is measured using the following:

- The finished surface of the office side of the wall that creates the hallway corridor and any other permanent building interior walls
- The center of the temporary partition that separates this office area from the office area of another tenant
- The inside surface of the dominant portion of the exterior wall

### An Example of Area Measurement

Looking at the office building in its entirety:

- The entire office building is 20,000 square feet.
- The square footage of the common areas is 3,333 square feet.
- Usable square feet: 20,000 total square feet - 3,333 square feet common area = 16,667 usable square footage.

$R/U \text{ Factor} = 20,000 \text{ rentable square feet} \div 16,667 \text{ usable square feet} = 1.2$

Looking at the rentable square footage of one office in this building:

- Distance A to C = 40 feet, measured from the inside of Wall A, which abuts the hallway and the inside of the glass wall (dominant portion).
- Distance B to D = 44 feet, measured from the center of the walls that separate this office from other offices.
- R/U Factor = 20,000 rentable square feet ÷ 16,667 usable square feet = 1.2 <sup>?</sup>  
Calculation of rentable square feet:

STEP 1:

40 feet

X 44 feet

1760 square feet of usable office area.

STEP 2:

1760 usable square feet

X 1.2; R/U Factor

2112 rentable square feet

When dealing with rentable and usable square footage, two terms which are used interchangeably, are efficiency factor and load factor. The use of these terms can cause confusion among office building owners, tenants, and agents.

Efficiency Factor

Efficiency factor measures how efficient the building is from the tenant's point of view. A building that is 100% efficient has no common area allocated to the tenant. In a building that has an efficiency factor of 100%, the usable square footage is equal to the rentable square footage. From the tenant's point of view, the higher the efficiency rating of a building, the less common area the tenant will have to have included in his rentable area.

In the previous example, the building has an efficiency factor of 83.33%.

$1/\text{RU} = \text{Efficiency Factor } 1/1.2 = 83.33$

If the usable space is 1,760 square feet and the building has an efficiency factor of 83.33%, tenants will pay rent based on 2,112 rentable square feet:  $1760/83.33 = 2112$

Load factor measures the amount of common area that is added to the usable area. A building that has a 0% load factor has no common area allocated to the tenants. In a building with a load factor of 0%, the usable square footage is equal to the rentable square footage. From the tenants' point of view, the lower the load factor in a building, the less common area tenants will have to include in their rentable area.

In the previous example, the building has a load factor of 16.67%.

$1-R/U = \text{Load Factor}$   $1-83.33\% = 16.67\%$

If the usable space is 1,760 square feet and the building has a load factor of 16.67%, then tenants will pay rent based on 2,112 rentable square feet.

Whether you use the efficiency factor or load factor in your calculations, you must be able to accurately measure the usable square feet.

While the office tenant uses 1,760 square feet, the rent will be based on 2,112 square feet.

An investment agent or broker working with office properties will need to be familiar with the BOMA® Standards. Keep in mind though, these measurement standards are not used for the measurement of retail or industrial properties.

## PROPERTY AND OWNERSHIP CHARACTERISTICS OF RETAIL

### PROPERTIES

A retail property might be a single building or a super regional mall. The purpose is still the same: to display and sell goods or provide services to the public. That is the point of any business; it is the only way to be a successful business.

Investors are attracted to retail properties, because retail properties demand even less direct management than an office building. Retail tenants are generally in their space longer hours than office building tenants. Retail tenants have grown accustomed to performing the traditional landlord responsibilities related to repairs, maintenance, and operating expenses. While the property owners have less management responsibility, they might take on more risk.

The first reason retail properties are considered more risky is that more than 50% of retail properties are single-tenant. In fact, there might be more single-tenant retail buildings than any other property type in the United States. While several of these properties might be located in one area, each property is a success only if the single tenant is successful. Generally, multi-tenant properties are considered less risky than single-tenant properties.

The second reason retail properties are considered more risky is because retail spending is the first area of discretionary spending. Remember what was said earlier? Employment and area play a role into buyers; if lay-offs occur or paychecks are small, then people will cut out spending needless money first. With the reduction of retail spending on the part of consumers, retail businesses might fail.

## HOW RETAILERS DETERMINE MARKET AREA OR TRADE AREA

Before investing in retail space, you or your Investor-Agent will need to know what is important to the retailers renting the investment space.

One of the most important characteristics is the market area itself. How many customers can they reasonably expect to see and will it be enough for the retailer to be profitable?

Retailers use one of four methods for determining Market Area:

1. In-the-door approach
2. Population/Expenditure approach
3. Customer Spotting approach
4. Drive-Time approach

The geographic area in which retail stores receive their continuous sales is called the market area, or trade area. Commercial and investment agents, working in retail, will have to learn how their clients define their market areas. Market area will be a prime determinant of the location of a retailer. Ideally, retailers would like to be located in the center of their market areas.

### Methods Retailers Use in Determining Market Areas or Trade Areas and Examples

**In-the-Door Approach (Drive-By):** This method of determining market, or trade area, deals with the question of how much vehicle traffic is required to support a location.

According to industry research, retailers know that based on traffic count information, a certain percentage of the traffic will stop and come “in the door.” Retailers want to know the traffic count that goes by their locations each day. This measure – of determining potential sales volume – would be important for strip centers and free-standing properties. The retailers in enclosed malls are interested in a different type of traffic – foot traffic – that goes in front of their store entrances.

EXAMPLE:

Facts:

- A store needs \$6,000 per day in sales volume.
- The average sale, based on customers who enter the store, is \$150.
- Of the customers who enter the store, 50% actually make a purchase.
- Of the drivers who pass the store, 0.2% enter the store.

Then:

- $\$6,000 \text{ sales volume per day} \div \$150 \text{ average sale} = 40 \text{ sales needed each day to meet the sales volume required.}$
- Assuming half of the customers entering the store make a purchase, 80 customers must enter the store so that 40 sales are made.
- Assuming two-tenths of one percent (0.2%) of drivers enter the store, 25,000 cars must pass by the store each day.
- As a result of this information, the retailer will look for a location where at least 25,000 cars drive by each day.

Population/Expenditure Approach: This method of determining a market, or trade area, is based on the population in the market area. Retailers would need to know how many dollars of sales per square foot are needed to support their stores. Once that figure is known, retailers will study industry averages to determine how many dollars are spent per capita. With these two factors, retailers will estimate how many people must be in their market area.

EXAMPLE:

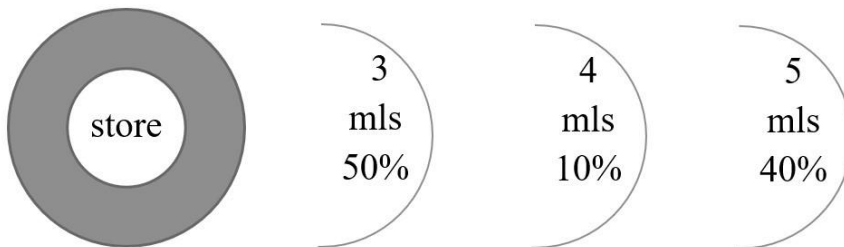
Facts:

- A store needs \$2,500,000 annual gross sales to be supported.
- On the products offered in this store, \$75 is the average annual amount spent per person.

Then:

- \$2,500,000 annual gross sales ÷ \$75 annual amount spent per person means 33,5000 people need to live in the market area or trade area of the store.
- As a result of this information, the store must be at a location where it can service 33,500 people.

Customer-Spotting Approach: This method of determining a market or trade area is based on the location of existing customers. Retailers get this information in two ways. First, the sales clerk obtains your address or zip code information when you buy a product; and second is in-store surveys, which obtain the same information as the first way.



Once this information is obtained, it is mapped. The retailer might determine whether the existing location is best, whether they should relocate, or add a second location. This information helps determine which would be advisable.

EXAMPLE:

Fact:

- The industry average is that people drive five miles or less to shop at similar stores.

Then:

- After using point-of-sale information and survey results, a retailer finds that 50% of the customers in the store come from within a three-mile radius; 10% come from between three and five miles away; and 40% come from more than five miles away.
- Perhaps the storeowner should research adding a second store four to five miles from the existing store before someone else does.

Drive-Time Approach: This method of determining market area is based on the theory that people will travel only so far to obtain a product. By studying the addresses of past customers, retailers can determine how far in miles or how long in minutes people are traveling to get to their location.

EXAMPLE:

Fact:

- Studies indicate that people will drive only five minutes to pick up a pizza or wait only 10 minutes for a delivery pizza.

Then:

- If the industry says that it takes 10,000 people in a market to support a pizza store, then a representative of the pizza company is actually driving the streets to determine the market area. How far can a delivery driver get in 10 minutes going north, east, west, and south? After plotting those points on a census tract map, the pizza company can determine how many people live within that driving-time area. If there are more than 10,000 people, the location should work.

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If you have ever been to Waikiki, you probably noticed an ABC store and McDonald's on every block. Since most people in Waikiki travel by foot, the location of the same retail

outlet is likely a result of the retailers knowing that people will walk only so far to buy products.

The International Council of Shopping Centers (ICSC) publishes material about the development, ownership, and management of shopping centers. Their information can be found at <http://www.icsc.org/>.

In their publication titled ICSC Keys to Shopping Centers Fundamentals Series: Overview, the three major classifications of retail properties based on the ICSC descriptions are Malls, Strip Centers, and Free Standing.

Malls are usually enclosed with a common area running between groups of stores. A feature of a mall is that there is a common parking lot, and customers enter the majority of stores from the enclosed common area.

A Strip Center is a row of stores attached to each other either in a straight line, an L-shape, or U-shape configuration. The stores may be attached with a canopy or common façade, but they do not generally have enclosed areas. A feature of a strip center is the parking, which allows customers to park close to the entrance of a specific store.

Freestanding retail buildings are numerous. A retailer simply has a building that sits by itself; it is not connected physically to any other building, and has its own parking area from which customers can enter the store directly. Fast food restaurants are common examples of freestanding buildings.

Eight Shopping Center Types:

1. Neighborhood Center
2. Community Center
3. Regional Center
4. Super Regional Center
5. Fashion/Specialty Center
6. Power Center
7. Theme/Festival Center
8. Outlet Center

Malls and strip centers are considered shopping centers. Whether a shopping center is configured as a mall or as a strip center, there are eight major classifications of shopping centers, which real estate agents should recognize.

1. **Neighborhood Center:** A neighborhood center serves a market area, and it provides day-to-day shopping convenience for consumers. Many of these centers have one anchor tenant, either a supermarket or drugstore. The anchor tenant(s) generally occupy 30% to 50% of the total size of the center. Smaller stores offering products or services needed by this market area's consumers are also found in a neighborhood center.

The size of neighborhood centers runs from 30,000 to 150,000 square feet, and the centers require 3 to 15 acres for the stores and parking.

2. **Community Center:** A community center serves a market area of approximately three to six miles; it provides the consumers in its market area with a wider range of retail and service stores. Many of these centers have two or more anchor tenants; they may be supermarkets, super drugstores, or discount stores. The anchors generally occupy 40% to 60% of the total size of the center. Smaller stores offering apparel, or other soft goods, make up the rest of the center. These centers are built in a strip-center configuration in a straight line, an L-shape, or U-shape. Some community centers are referred to as discount centers.

The size of community centers runs from 100,000 to 300,000 square feet, and the centers require 10 to 40 acres for the stores and parking.

3. **Regional Center:** A regional center serves a market area of approximately 5 to 15 miles, and it provides the consumers in its market area with general merchandise and primarily apparel. Many of these centers have two or more anchor tenants, which might be full-line or junior department stores, mass merchandisers, and discount department stores. The anchors generally occupy 50% to 70% of the total size of the center. These centers are built in a mall configuration with inward orientation of stores connected, which can be accessed by a common walkway and with parking surrounding the center.

The size of regional centers runs from 400,000 to 800,000 square feet, and the centers require 40 to 100 acres for the stores and parking.

4. **Super Regional Center:** A super regional center serves a market area of approximately 5 to 25 miles, and it provides the consumers in its market area with a

deeper selection of merchandise through multiple anchors. Just as regional centers, the anchors generally occupy 50% to 70% of the total size of the center; these centers are built in a mall configuration, which are connected by a common walkway. Many super regional centers need to be multilevel.

A super regional center is generally larger than 800,000 square feet and requires 60 to 120 acres for the stores and parking.

5. Fashion/Specialty Center: A fashion/specialty center serves a market area of approximately 5 to 15 miles, and it provides the consumers in its market area with the following: upscale apparel shops, boutiques, and craft shops. Many of these centers do not actually have anchor tenants, but have restaurant or entertainment tenants. These centers can be built in a mall configuration or a strip configuration, but the landscaping is always high quality.

The size of a fashion/specialty center runs from 80,000 to 250,000 square feet, and the center requires 5 to 25 acres for the stores and parking.

6. Power Center: A power center services a market area of approximately 5 to 10 miles, and it provides the consumers in its market area with home improvement stores, discount department stores, warehouse club stores, or off-price stores. There are usually three or more anchors, and these anchors are often referred to as “category killers.” There are few additional retailers in a power center, and the anchors might comprise up to 90% of the square footage of the center.

The size of power centers runs from 250,000 to 600,000 square feet, and the center requires 25 to 80 acres for the stores and parking

7. Theme/Festival Center: A theme/festival center does not generally serve a defined geographic market area. The concept behind a theme/festival center is to provide leisure and tourist-oriented retail and services. The biggest appeal of this type of center is to tourists. Restaurant or entertainment facilities serve as the anchor tenants. Generally located in an urban area, this kind of center is often found in an older, sometimes historic building. Configuration of theme/ festival centers can be either mall or strip centers.

The size of a theme/festival center runs from 80,000 to 250,000 square feet, and the center requires 5 to 20 acres for the stores and parking.

8. Outlet Center: An outlet center is usually located in a rural or tourist location. The market area might range from 25 to 75 miles. The biggest appeal of this type of center is to consumers, who want to buy products from manufacturers' outlet stores, where namebrand merchandise can be purchased at a discount. Generally not anchored, the configuration of outlet centers resembles that of strip centers, but some are arranged in a "village" cluster.

The size of an outlet center runs from 50,000 to 400,000 square feet, and the center requires 10 to 50 acres for the stores and parking.

Commercial or investment agents and their investors, choosing to work in retail, must understand the differences between the shopping center types and will need to include these terms in their vocabulary.

### Industrial Properties

The Urban Land Institute defines industry as the following: "The gainful activity involved in producing, distributing, and changing the form of raw materials; or assembling components and parts, packaging, warehousing, and transporting finished products." Urban Land Institute information can be found at <http://www.uli.org/>.

Industrial properties house the process of manufacturing, warehousing, and distributing the products. Industrial properties are primarily devoted to these activities, but may have some minor part of the building devoted to office space.

The National Association of Industrial and Office Properties, NAIOP<sup>®</sup>, is a very good source regarding information for industrial properties. Its website is [www.naiop.org](http://www.naiop.org).

Investors who want to minimize their involvement with property management and contact with tenants invest in industrial properties. Tenants often pay all of the expenses and do all the maintenance of the property. While many tenants in industrial properties are national firms, there is risk associated with investments in industrial buildings, because there is usually only one tenant. When that tenant moves out, the building may need substantial renovation to be attractive to a new tenant, and there may be a lengthy period of time during which the building sits empty. Investors accept this extra risk in return for the elimination of management involvement.

# Determining the Basic Needs of a Successful Industrial Investment Property

One of my earliest experiences in industrial space had to do with a Volkswagen plant in Western Pennsylvania. Years ago they packed up and left the region in a bit of a funk! Rumor was that management discovered that factory workers were drinking beer on the job and hid the empty cans in the rocker panels of the cars coming off the assembly line. Consumers complained of a mysterious rattling noise and upon inspection discovered the empty beer cans! This is part of what presumably led to Volkswagen leaving the area. In any case, as you might imagine, the facility was empty for years. How'd you like to have a large industrial plant that you owned empty for years? Well, this is why I suggest that industrial space is perhaps the most risky of the four major types of investment spaces. On the other hand, as you might imagine, tenants of industrial space usually stay a very long time. The facility was eventually occupied by SONY! So, let's dig into some facts to help you determine whether or not you want to participate in the world of industrial space investing.

In general, an industrial property needs four main items to be successful:

1. Access to transportation
2. Available labor pools
3. Availability of heavy duty utility services
4. Proper zoning and use permits

## Access to Transportation

Transportation of industrial properties include heavy-duty local roads, metropolitan freeway systems, regional railroad systems, national airway systems, or a combination

of all four. Large warehouses also need large amounts of land to accommodate bulky goods being transported.

#### Available Appropriate Labor Pool

Data about the labor pool would include: the number of workers available, how close the labor pool is to the facility, and the current wage and benefit packages being paid to these workers.

#### Availability of Heavy-Utility Services

Industrial properties need heavy-duty utilities, such as sanitary sewer and treatment facilities, water supply, treatment and distribution facilities, natural gas, heavy electricity service, telecommunications services, and possibly fiber-optic cables.

#### Proper Zoning and Use Permits

Over the years, the zoning restrictions placed on industrial properties have become more restrictive.

Along with general zoning restrictions, new concepts, such as Planned Unit Developments (PUDs) and floating zones, have been developed to allow innovative approaches to the use of land.

Zoning regulations for industrial properties are designed to create planned employment centers, which benefit the employees and the neighbors of the industrial properties.

Industrial businesses need skilled workers. Businesses study what the trends are in employment, as they relate to the availability of workers.

## THE VARIOUS WAYS TO CLASSIFY INDUSTRIAL BUILDINGS

Industrial properties are often classified by the way they are used. Common classifications are:

1. General Purpose
2. Special Purpose
3. Single Purpose



### General Purpose Industrial

General-purpose buildings are those with a wide range of alternative uses. This is the most common type of industrial property. They can be adapted to light manufacturing, assembly, storage, or distribution. These buildings are often built on spec, meaning that developers build the building before they have a specific tenant.

### Special Purpose Industrial: Refrigerated Storage



Special-purpose buildings have physical characteristics or facilities suitable to a smaller range of uses. An example is a refrigerated storage facility or airplane maintenance hangar.

Single-purpose buildings are adaptable to only one particular process or one particular firm. Examples would be grain silo or petroleum refinery. The more specific a building is designed, the less convertible the building is to other uses.

#### Single Purpose

Many times industrial usage requires mostly vacant land, as in this electrical distribution yard.

## LOCATIONS OF INDUSTRIAL PROPERTIES

Industrial properties are located in a variety of ways. Freestanding buildings are those that stand by themselves. They are usually the largest of the properties. Multi-tenant properties are home to the smallest tenants who need industrial properties. Industrial parks are single properties managed by one entity, and they may be home to both freestanding properties and multi-tenant properties.

## COMMON CLASSIFICATIONS OF INDUSTRIAL INVESTMENT PROPERTIES BY TYPE INCLUDE:

1. Bulk
2. Manufacturing
3. Office/Warehouse
4. Research and Development

#### Bulk

Think of industrial places that utilize sand or stone; most of the time, these enclosures are semi-circular with a roof, allowing transportation easy access. These buildings are large, many times 50,000 square feet or more. There is little need for office space. Loading docks, parking surfaces, and ingress and egress roads must be heavy duty, to accommodate the transportation methods of getting the inventory to and from the building. Many properties need rail service.

## Manufacturing

Manufacturing plants are large buildings, often more than one million square feet, and are quite specialized to meet the specific needs. The properties must accommodate receiving, production, and shipping activities. These properties are prone to obsolescence, because production methods are constantly changing, and the configuration of the building must change, or it is no longer useful.

## Office/Warehouse

Office/warehouse properties are used for the storage and distribution of products, where some portion of the building is developed into office space. Although many of these properties are constructed of concrete or metal, the newer trend is to use brick.

## Research and Development

Research and development properties are popular with investors, because they are generally located near universities and white-collar labor forces. These buildings are standard in construction, but are highly improved through specific tenant improvements. Rent is higher than it is for industrial-type properties, because these properties are often seen as a hybrid between an office building and a manufacturing building.

## Industrial Parks

Industrial buildings are often grouped by use or type, in a development called an industrial park. The National Association of Industrial and Office Parks (NAIOP) has issued Industrial Park Criteria and Standards. Information regarding NAIOP can be found at their website [www.naiop.org](http://www.naiop.org)

The NAIOP's definition of an industrial park is the following:

The assembly of land provides facilities for business and industry consistent, with a master plan and restrictions. This results in the creation of a physical environment that achieves the following objectives:

- Consistency with community goals
- Efficient business and industrial operations

## COMMERCIAL PROPERTIES

- Human scale and values
- Compatibility with natural environments
- Achieving and sustaining highest land values

Some characteristics NAIOP looks for in an industrial park are:

- Paved streets
- Adequate utility system for multiple tenants
- Adequate landscaping
- Architectural control of site, buildings, and signage
- Supervision of environmental issues
- One management plan

# Finance

## USE SUPPLY AND DEMAND TO DETERMINE VALUE

Economists have wrestled (MMA style) for hundreds of years with the question of what determines value. The so-called classical economists (probably geeks, I mean Greeks) believed it was the labor that gave a product its value. Others focused on its rarity – the rarer, the greater its value (e.g., diamonds, spices, or gold). It was not until around the turn of the 20th century that they zeroed in on the interaction of supply and demand. A paraphrase of the great analogy penned by Alfred Marshall in 1890 sums up the interaction: “You can no more tell which determines price, supply or demand, than you can tell which blade of the scissors does the cutting. It is the interaction of the two that does the work.”

### Supply

The supply of real property is the amount of space that will be offered for sale or rent at a given time at a given price. It is influenced by the following:

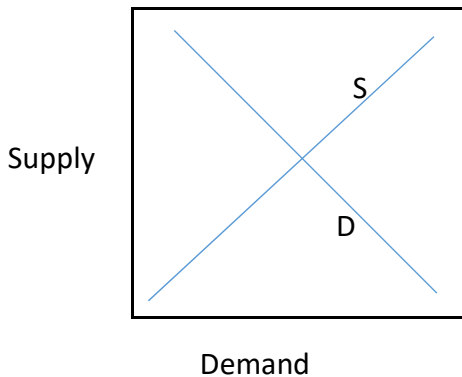
- Costs of producing the space
- Sellers’ needs and intent
- Perceptions of market condition
- Zoning practices

### Demand

The demand for real estate is the amount of space that will be bought or rented at a given time and price. Demand is influenced by the following:

- ☐ Alternative space available
- ☐ Market conditions for the buyer's or tenant's products
- ☐ Perceptions of market conditions

### Supply - Demand Curves



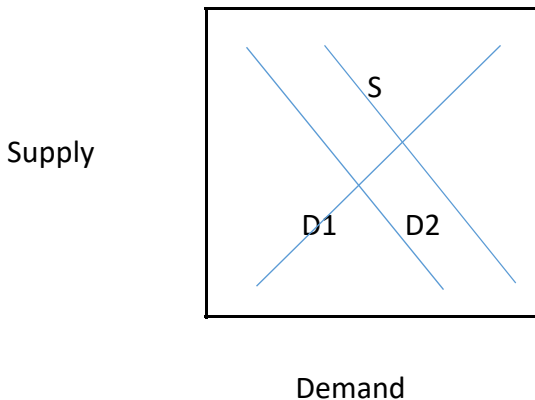
The supply curve (S) tilts upward and to the right – as the price for space increases, more and more will be offered for sale or lease as landlords, builders and sellers look for increased profits.

The demand curve (D) tilts downward and to the right – as the price for space decreases more and more will be bought or leased, because more users will be able to buy or lease.

**Equilibrium Point:** The price at which both buyers, sellers, landlords and tenants come together is the equilibrium point (or sweet spot), for that transaction. Each is satisfied, since this is the best price available for a specific real estate product. The equilibrium point is shown as the intersection of the supply and demand curve.

Small changes occur all the time to move the equilibrium point up or down each curve. These are small changes of relatively short duration, after which the market returns to normal and is stable again. But what happens when there is a major change in the market? For example, what happens to a market for retail space and hotel space when Disneyland opens a new theme park? This dramatic change is certainly not temporary, and therefore the old supply and demand curves are modified.

Major changes such as this create what is called a shift in the supply-demand curves. A whole new set of curves becomes relevant, and a considerable disruption in the market can be expected:



We have not traveled up or down the demand curve. We have seen a complete shift in demand from one demand curve (D1) to a new demand curve (D2). More tenants are demanding space from a fixed supply of space. A new equilibrium will be found, and this market situation would be called a seller's market.

Simplistically, it could be said that the real estate market can be described as a marketplace made up of people, property, and money.

### The Real Estate Marketplace

- People Looking for Property
- Money Looking for Property
- Property Looking for Money
- Property Looking for People
- People look for property.
- Property looks for people – vacant properties look for tenants by owners.

- Money looks for property – lenders look to place money into loans backed by real estate and investors look to place money into real estate ownership.
- Property looks for money – properties look for lenders.
- In a perfect world of supply and demand, there is a balance of people, properties, and money. If the supply of properties available gets out of balance, then there will be a change in the pricing of the properties.
- While the dot-com businesses were forming, the number of people looking for space increased, but the supply of space remained constant. The price of the space went up, and builders entered the market to build new spaces because of the higher potential rents. This situation is called a seller's market. When that market contracted, the number of tenants decreased, the supply stayed constant, and the price for properties decreased. This situation is called a buyer's market.

If the supply of money gets out of balance with the demand for properties, then there will be a change in cost of money. When the supply of money available from lenders decreases, interest rates increase. When the supply of money increases, lenders must lower interest rates to give borrowers an incentive to buy new properties or refinance.

## UNDERSTANDING POSITIVE LEVERAGE

Generally, the term leverage refers to using financing to acquire a property. The statement: "The property was acquired using 75% leverage" means that an investor obtained financing in the amount of 75% of the total purchase price of the property. The remaining equity of 25% was invested in cash.

Positive leverage occurs when the yield on a property purchased on an unleveraged basis (i.e., free and clear) is greater than the interest charged by the lender. Then the yield to the investor using leverage will be higher if they use financing to purchase the property.

Let's look at an investment and break it into three parts: the property, the lender, and the investor.

### EXAMPLE:

- A property can be purchased for \$500,000 by paying all cash.

- The first year, net operating income (NOI) of the property is \$50,000 and is expected to remain the same for two years.
- It is expected that the property can be sold at the end of the second year to net \$500,000 after selling costs.

#### A) Property Free and Clear

- Purchase Price (\$500,000)
- Year 1 NOI \$50,000
- Year 2 NOI \$50,000
- Sale Price \$500,000
- Unleveraged Yield = 10%

In this case, the yield to the investor on an unleveraged, or free-and-clear, purchase is 10%. The investor pays \$500,000 cash to purchase the property and gets \$50,000 back each year in net operating income (NOI). Because there are no loan payments to be made, the investor keeps the \$50,000 each year. The yield is 10% based on the \$500,000 the investor has invested. The investor gets a full return of the investment at the sale because there is no loan to pay off.

$\$50,000 \text{ NOI} \div \$500,000 \text{ Purchase Price} = 10\% \text{ yield}$

The property produces a 10% return based on operations and the projected sales price if purchased without financing.

#### B) Lender

We will add the lender's position in this transaction.

Instead of buying the property for cash, the investor can obtain a 70% loan to value (LTV) loan from a lender. To make the calculations easy, the terms are 8%, interest only, with annual payments.

- $\$500,000 \text{ Property Price} \times 70\% \text{ Loan to Value (LTV)} = \$350,000 \text{ loan. } \text{[2]}$   
 $\$350,000 \text{ loan} \times 8\% \text{ interest rate} = \$28,000 \text{ in annual debt service.}$

In this case, the yield to the lender is 8%. The lender gets \$28,000 back each year, based on the \$350,000 it has invested. Because this is an interest-only loan, the lender gets a full return of its investment when the loan is paid off at the sale of the property.

### C) Investor Using Leverage

As we will see, this is an example of positive leverage, because the yield on a purchase of the property – on a free-and-clear basis – is higher than the interest rate charged on the loan.

By adding the investor's position to this transaction, you will see the effect of using positive leverage.

- The investor will have to put \$150,000 down to purchase the property.
- The investor will receive \$22,000 in cashflow, after making the loan payments.
- The investor will receive \$150,000 on the sale of the property, as a result of receiving the Sale Price and paying off the loan.

### What Is Really Happening?

What is really happening here is that the property produces a 10% yield. The lender actually buys 70% of the property but takes only 8% on the part it buys, leaving 2% for the investors.

The investors buy 30% of the property, receive 10% on the part they purchase, and 2% on the part of the property the lender purchases.

The effect of positive leverage is that investors will achieve a higher yield. This only happens if they purchase the property using the available financing, rather than if they purchased the property on a free-and-clear basis.

## UNDERSTANDING NEGATIVE LEVERAGE

Negative leverage occurs when the yield on a property purchased on an unleveraged basis is lower than the interest charged by the lender. If we look at the same investment but change the interest rate on the loan to 12%, we will see the effect of negative leverage.

Assume in the last example – where the yield on the property remains at 10% – the interest rate is 12%. This would be negative leverage.

What is happening here is that the property still produces a 10% yield. The lender actually buys 70% of the property but takes a 12% yield on the part it buys. The property produces only 10%, so it must take its additional 2% from the investor.

The investor buys 30% of a property, yielding 10%, but must give 2% to the lender. As a result, the investor's yield will be less than 10%.

The effect of negative leverage is that investors will achieve a lower yield if they purchase the property using the available financing than they would if they purchased the property on a free-and-clear basis.

## NEUTRAL LEVERAGE

Neutral leverage occurs when the yield on a property purchased, on an unleveraged basis, is the same as the interest charged by the lender. If we look at the same investment but change the interest rate on the loan to 10%, then we will see the effect of neutral leverage.

What is happening here is that the property produces a 10% yield. The lender actually buys 70% of the property and takes a 10% yield on the part it buys.

The investors buy 30% of a property yielding 10% and get the 10% on the part they buy.

In neutral leverage the investor and the lender get their share of the yield on the property, and neither party has to give any share to the other party.

The effect of neutral leverage is that investors will achieve the same yield. This works if they purchase the property using the available financing, as they would if they purchased the property on a free-and-clear basis.

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Agents who want to become involved in investment real estate will need to understand financing.

If agents decide to become involved with investment real estate, they will have to become familiar with the types of financing used by investors – how investors and the properties qualify for loans, and the reasons investors use financing to purchase properties.

## UNDERSTANDING PRICE VERSUS VALUE

A comment heard frequently on the street is: “I bought it below market.” In fact, there is no such thing. A property may be purchased at a price lower than it had been previously offered or lower than the price of a similar property. But at the moment a sale takes place, that is the market price for that property. The stock market is an excellent analogy, because transactions in a particular stock occur daily in a range of prices. Each transaction is at the market price at that time.

Are price and value the same thing? Not really. Price is simply what the buyer had to give up in order to acquire the property. The value to the buyer might be much greater. We will discuss the sources of value in the next section, but for now let’s identify the types of value to get a perspective on this elusive term.

Types of Value in Commercial Investment Real Estate:

- Assessed Value
- Insurance Value
- Loan Value
- Investment Value
- Appraised Value
- Liquidation Value

### Assessed Value

The assessed value must be determined by the tax assessor to set the level of taxes on a property. Each state and county has its own rules the assessor must follow.

### Appraised Value

A qualified appraiser establishes an appraised value using the cost, income, and comparative approaches to value. An appraiser is usually asked to estimate the market value for the property. Market value can be defined as: the price a typical investor will pay for a property based on its highest and best use. Each investor has their own opinion of the market value. Lenders rely on appraisal values as a way to estimate the selling price a property will command.

### Insurance Value

The insurance value is the value of that portion of a property, which can be damaged or destroyed in a catastrophe but can be replaced with insurance proceeds.

### Investment Value

The investment value is the value an individual investor assigns to a property. Generally, investment value is determined by some discounted cashflow strategy, based on the investor's opportunity cost or cost of capital.

Investors care about the market value, because they do not want to pay more for the property than a typical buyer would pay. However, there are always exceptions. An example would be the office building owner, who wants to buy the adjacent single-family houses around the office building; this could allow a parking increase.

Three approaches are used in determining investment value in investment or commercial real estate.

1. Income approach
2. Cost approach
3. Comparable approach

The income approach requires the projection of cashflows from acquisition, operations, and disposition of the property. These cashflows are discounted to determine their present value. Sometimes the capitalization rate is used to determine the value of the property by the income approach to value.

The cost approach is basically looking at how much it would cost to replace the property. If the property being considered is not new, consider depreciation of the improvements.

Depreciation is used to deal with the property, because it may be in poor repair or it may be outdated functionally.

The sales comparison approach uses a survey of recent sales of similar properties, to estimate the value of the property being considered. The total sales prices are usually divided by some measurement of unit; this helps to give a comparable value based on a standardized unit.

Additionally, adjustments to the value per unit calculated, are made to adjust among the comparable for items: age, condition, and location. There is usually a range of values estimated by the comparable approach, or there is a value established by using the average of the comparable properties being studied.

### Liquidation Value

The liquidation value is the value a property would bring if it sold through a distressed sale, such as a foreclosure.

### Loan Value

The lender assigns a loan value to a property that is used as security for a loan. This amount represents the lender's desire for yield and appetite for risk. It is a value specific to the lender, not the borrower.

### Value in Use

Value in use is the value of a particular piece of real estate. Some users of real estate actually own the real estate; some users are tenants in real estate owned by others. Generally, value deals with how the real estate being used will contribute to the profitability of the business. Not all users of real estate want to own their real estate.

## THE IMPORTANCE OF APPRAISALS AND DETERMINING VALUE

Appraisals in residential real estate are different from those found in commercial and investment real estate. The most common method of determining an appraised value – in a residential property – is the sales comparable approach. In this approach, sales of similar houses in similar neighborhoods are tracked to determine a value.

In commercial and investment property, the appraiser is concerned with comparable sales data, but is also concerned with the income the property is expected to produce

on investor properties. This is because the income is what supports the ability to make the loan payments, and it also pays the reproduction cost of the property.

Describe the concept of values in commercial and investment real estate

We might think that price, cost, and value mean the same thing; but for appraisal purposes, each term might have a different meaning. It is possible that the price, cost, and value might be the same, but very likely they are different.

Price

Price refers to the asking price or the selling price of the property. This is the amount that is being offered for a property today or paid in the past. This value approach reflects the price one person has determined, which is what he or she will pay for a specific property.

Cost

Cost is either the actual amount paid for property in the past, or the dollar amount needed to build the property. This value approach reflects either a historic number or a number in the future, and it is difficult to apply to the entire market.

Value

Usually, value is defined as the power of goods or services to command other goods or services in the marketplace.

A real estate example is the agreement of tenants to sign leases. The tenants have agreed to exchange their money, in return for the use of the property. Both the tenants and the landlords have agreed to exchange goods and services, and that exchange establishes a value for the use of the property.

Market Value

Market value is a term defined in the appraisal profession. The Uniform Standards of Professional Appraisal Practice (USAP) has defined value as follows:

“The most probable price a property would bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting

prudently and knowledgeably and assuming the price is not affected by undue stimulus.”

Assumptions in this definition are the following:

- Buyer and seller are typically motivated
- Buyer and seller are well informed or can obtain competent advice <sup>?</sup> Buyer and seller are acting for their best interest
- The property has been exposed to the market for a reasonable time
- Payment is in cash or in comparable financing terms
- Price represents normal terms unaffected by special or creative financing or unusual sales concessions

Highest and Best Use (HABU)

The Highest and Best Use of a property is the legal use of a property that will yield the highest present value.

A commercial or investment property may have several values, depending on how the property can be used. For example, a vacant lot might be the site for an apartment building or a retail store. An old warehouse in the downtown district may have more value as loft apartments than it would as a warehouse.

The definition of highest and best use is:

...the most probable use of land or improved property that is legally possible, physically possible, financially feasible (and appropriately supportable) from the market, and which results in maximum profitability.

Remember, creativity is the key!

The four criteria the appraiser will consider in a highest and best use analysis are the following:

- The use is physically possible.
- The use is legally possible.
- The use is financially feasible.

- The use offers the maximum productivity.

The analysis of the highest and best use of a property involves two considerations: 1) the most likely and profitable use of the site; 2) if a property is “already improved,” what use could help maximize the property’s value.

Basic highest and best use assumptions include:

- The competitive level will dictate whether an area is best used for commercial, residential, or multi-family. Zoning could present a problem though. If market preference conflicts with zoning – and consequently violates the legal permissibility test – a developer will consider: if there is enough profit incentive to justify the added costs before obtaining a zoning change and developing the site.
- As long as the value of the property “as improved” is greater than the value of the site as “if vacant,” the best use is usually the “improved” property.
- Once the value of the vacant land exceeds the value of the improved property (including demolition costs), the highest and best approach will usually dictate that improvements be demolished.

Sometime the highest and best use is not always determined by the economic benefits, but some other element important to the community. An example would be turning vacant land into a park on a beach front.

## APPRAISAL APPROACHES TO MARKET VALUE

In an appraisal of a commercial or investment piece of real estate, the appraisal will contain three approaches to value.

1. Sales comparison
2. Cost
3. Income

The appraiser's opinion of value will blend all three approaches, or will state that one approach outweighs the others to such an extent that maximum weight will be given to that approach.

### Sales Comparison Approach

In the sales comparison approach, the appraiser is trying to establish value based on the prices buyers have paid for similar properties in the past.

The steps the appraiser takes in the sales comparable approach are the following:

- Find the comparable sales that have occurred recently.
- Adjust the comparable property values for variances with the property under consideration.
- Net the adjustments.
- Select the value of the property under consideration, giving greater weight to the properties that are most similar.

If there are many sale comparables, then this method of determining value can be effective. It can be less effective when there are few sale comparables.

This method is given weight in the sale of similar properties. The best method of determining the value of four-unit apartment buildings in a neighborhood, might be to look at the recent sales of similar properties.

For example, an appraiser might find four recent sales of four-unit apartment buildings all built by the same builder in the same year, in the same neighborhood. No adjustments need to be made. The sales prices are as follows:

- Sale #1 \$ 475,000
- Sale #2 \$ 500,000
- Sale #3 \$ 525,000
- Sale #4 \$ 500,000

Total \$2,000,000 ÷ 4 Sales = \$500,000 Value

The sales comparison approach would set the value at \$500,000.

## Cost Approach

The cost approach to value considers the cost of reproducing the property, minus any depreciation that has taken place.

The steps the appraiser uses in the cost approach are the following:

- Estimate the cost to reproduce the existing building, and make any required improvements.
- Estimate the amount of depreciation that has taken place.
- Subtract the amount of depreciation from the cost to reproduce the building.
- Estimate the value of the land.
- Add the value of the land to the depreciated value of the building.

The cost approach is often the most important for users of commercial and investment real estate. Users always consider whether they should buy an existing building or build a new building.

For example, an existing building appraises for \$1,550,000.

The cost to build a new building and the site improvements	\$1,000,000
Less: The amount of depreciation in the existing building	350,000
Plus: The cost of the land	700,000
Total per the cost approach	\$1,550,000

Income Approach

$I = \text{Net Operating Income (NOI)}$

$R = \text{Cap Rate}$   
 $V = \text{Value}$

Therefore:

$R = I/V$

And

$$V = I / R$$

And

$$I = R \times V$$

The income approach is used when the property being appraised is being rented or could be rented to tenants. Investors like this approach, because the appraiser determines the value based on the income the property produces.

The income approach is effective because it looks at the property and determines value as an investor does. The investor is essentially buying the cashflows the building produces. The income approach is rarely used in the appraisal of residential properties occupied by the owner.

#### Capitalization Method Based on Comparables

The capitalization method determines value by applying a market yield rate to a market net operating income (NOI). The capitalization method uses the IRV formula. The appraiser will use the following steps:

- Select comparable properties that have sold.
- Determine the selling prices and NOIs for each sale.
- Calculate the cap rate for each sale.
- Calculate an average cap rate for the market.
- Convert the terms in the IRV formula to terms used in real estate so we can calculate value, cap rate, or NOI.

This method is effective when there are adequate sales in the market, allowing the appraiser to develop the comparable cap rate.

#### EXAMPLE:

	<u>Sale Price</u>	<u>NOI</u>	<u>Cap Rate</u>
Sale #1	\$200,000	\$20,000	10.0%

THE MASSIVE PASSIVE CASHFLOW METHOD

Sale #2	\$225,000	\$20,250	9.0%
Sale #3	\$250,000	\$24,000	9.6%
Sale #4	\$200,000	\$18,000	<u>9.0%</u>
Average Cap Rate			9.4%

The Cap Rate the appraiser would use is 9.4%.

Application: If the NOI of the property being appraised is \$20,000, then the value would be \$212,800 ( $20000/9.4\% = 212,766$ , rounded to 212,800).

Deriving a Cap Rate When There Are No Comparables

There are times when a property is too specialized, or there is a lack of comparable sales, so the appraiser must use a mathematical approach to build or derive a cap rate. (Hopefully, you paid attention in all your math classes!)

This can be a very complicated process, but here is a simple example. In the market, lenders are making 75% loans and want a 10% interest rate. Investors, who must make a 25% down payment, want a 15% yield. The cap rate needed to meet both the lenders' and investors' goals would be determined by the following calculation:

	Amount Invested	X	Desired Yield	=	
Lender	75%	X	10%	=	.0750
Investor	<u>25%</u>	X	15%	=	<u>.0375</u>
Total	100%				.1100

COMMERCIAL PROPERTIES

The Cap Rate needed must be 11%. If the NOI is \$20,000 and the derived Cap Rate is 11% the value of the property is \$181,800 ( $20000/11\%=181818$ , rounded to 181800). This mathematical formula is sometimes called the weighted average or band of investment.

Let's see if this approach meets the needs of the investor and the lender if the price is \$181,800.

Lender's Position:

- $\$181,800 \text{ Price} \times 75\% \text{ Loan to Value (LTV)} = \$136,350 \text{ Loan}$
- $\$136,350 \text{ Loan} \times 10\% \text{ Desired Yield} = \$13,635 \text{ Annual Debt Service (ADS)}$

Investor's Position:

- $\$181,800 \text{ Price} \times 25\% \text{ Equity} = \$45,450 \text{ Down payment}$
- $\$45,450 \text{ Down payment} \times 15\% \text{ Desired Yield} = \$6,818 \text{ Cash Flow}$

Total Property Position:

\$20,000	NOI
<u>-13,635</u>	Annual Debt Service (ADS)
\$ 6,363	Cashflow (slight difference in rounding)

Let's see whether this approach meets the needs of the investor and the lender if the price is \$200,000, which represents a 10% cap rate.

Lender's Position:

- $\$200,000 \text{ Price} \times 75\% \text{ Loan to Value (LTV)} = \$150,000 \text{ Loan}$
- $\$150,000 \text{ Loan} \times 10\% \text{ Desired Yield} = \$15,000 \text{ Annual Debt Service (ADS)}$

Investor's Position:

- $\$200,000 \text{ Price} \times 25\% \text{ Equity} = \$50,000 \text{ Down payment}$
- $\$50,000 \text{ Down payment} \times 15\% \text{ Desired Yield} = \$7,500 \text{ Cashflow}$

Total Property Position:

\$20,000	NOI
<u>-15,000</u>	Annual Debt Service (ADS) \$
5,000	Cashflow

The \$5,000 cashflow available for the investor is less than the \$7,500 needed to achieve a 15% yield. The investor would be willing to pay only \$35,700 (rounded) for a \$5,000 annual cashflow based on a 15% desired yield. Therefore, the property would be worth only \$185,700 (\$150,000 + \$35,700).

Discounted Cashflow Method

The capitalization method considers only the income from the first year of the property operations. To look at all the cashflows, the appraiser would use the discounted cashflow method of determining the present value of the cashflows discounted at a required yield. This method of appraisal takes into account the time value of money strategy, and is beyond the scope of this book. (Once again, I hope you paid attention in math class!)

# Common Investor Rules of Thumb Found in the Marketplace

As in any business, there are rules of thumb that evolve in everyday use. Most of them are not grounded in solid analytical theory, but they have a long, useful life. Investment real estate is no exception.

Agents working in residential real estate should be familiar with these rules of thumb. All of them have major flaws in their concept. This chapter will only briefly outline what the rules of thumb are, how to calculate them, and what their shortcomings are.

## Cost Per Square Foot

Cost Per Square Foot = Total Cost of Property / Total # of Square Feet

This rule of thumb is a tool for making cost comparisons. It is used by breaking a building down into its smallest part, and then comparing the cost of a square foot in the building, to the cost of a square foot in a comparable building. Owners of real estate are interested in the cost per square foot, because the building will not produce any rental income when occupied by the owner user.

To calculate the cost per square foot, divide the asking price of the building by the number of square feet in the building.

$\$900,000 \text{ asking price} / 10,000 \text{ sq. ft.} = \$90/\text{sq. ft.}$

Once you know the number of square feet in the building being considered, you could multiply the number of square feet by some standard value to determine the value.

$10,000 \text{ sq. ft.} \times \$90/\text{sq. ft.} = \$900,000 \text{ value}$

One obvious problem is there is no valid standard value. No two buildings are alike, even if built at the same time by the same builder.

Another problem is that this measure does not take into consideration the income generated by the building or the expenses of operating the property. Is a vacant building worth more or less than an occupied building?

Users of real estate use this rule of thumb primarily to compare different locations for their businesses. If one vacant office building can be purchased at \$80 per square foot, and another building is available at \$65, we have a difference in cost and must ask why there is a difference.

## CASHFLOW MODEL

The remaining rules of thumb deal with the cashflow generated from a property. The Cashflow Model is a standard approach to looking at the cashflow of an investment piece of real estate.

Potential Rental Income

- Vacancy

= Effective Rental Income

+ Other Income

= Gross Operating Income

- Operating Expenses

= Net Operating Income (NOI)

- Annual Debt Service (ADS)

= Cashflow Before Tax (CFBT)

Gross Rent Multiplier (GRM)

$GRM = \text{Total Cost of Property} / \text{Potential Rental Income}$

The gross rent multiplier (GRM) is a comparison tool used by investors to see how many years it will take to earn back the purchase price of property through rent. It is often

used by investors of smaller, similar multi-family properties because income and expenses are similar.

The gross rent multiplier (GRM) is calculated by dividing the value of the property by the potential rental income for the first year.

$$\$900,000 \text{ Value} \div \$100,000 \text{ Potential Rental Income} = 9 \text{ GRM}$$

A nine gross rent multiplier (GRM) would be expressed as a “GRM of 9,” or “9 times gross.”

This means that it would take nine years to collect enough rents to earn back the price of the property. As a comparison tool, we can now look at payback periods to value investment real estate. Similar properties should have similar payback periods.

Assume that the last six transactions on four-unit residential properties resulted in a gross rent multiplier (GRM) of eight. Two new listings have come on the market, one with a 9 GRM and one with a 7 GRM. Can you begin to make some value comparisons?

If you know a standard value for gross rent multipliers (GRMs) and the potential rental income, then you can determine the value of a property by multiplying the potential rental income by the GRM.

$$\$100,000 \text{ Potential Rental Income} \times 8 \text{ GRM} = \$800,000 \text{ Value}$$

$$\$800,000 \text{ Value} / 8 \text{ GRM} = \$100,000 \text{ Potential Rental Income}$$

The weakness of the gross rent multiplier (GRM) – as a value comparison tool – is found in the fact that this rule of thumb depends on first-year potential rental income only. It does not take into consideration items in the cashflow model below potential rental income, such as vacancies, operating expenses, or financing.

### Calculating Cap Rate

$$\begin{aligned} & \text{Potential Rental Income} \\ & - \text{Vacancy} \\ & = \text{Effective Rental Income} \\ & + \text{Other Income} \end{aligned}$$

- = Gross Operating Income
- Operating Expenses
- = Net Operating Income (NOI)
- Annual Debt Service (ADS)
- = Cashflow Before Tax (CFBT)

Which of these apartments do you think has more value? Apartment building A has tenants pay \$100,000 rent, and they pay all of their own utilities; apartment building B has tenants pay \$100,000, but the owner pays all the utilities. Both properties are priced at \$800,000, too. The answer: both, because they both have a GRM of 10!

Capitalization Rate (Cap Rate)

Net Operating Income (NOI)

Cap Rate = NOI / Purchase Price

In economics, the term “to capitalize” means to convert an income stream to a value.

With the capitalization rate tool, if you know the net operating income (NOI) of a property, then you can calculate a value by dividing the income stream by the rate of return desired.

EXAMPLE:

If you have an opportunity to buy real estate that produces \$90,000 of Net Operating Income (NOI) each year, and you want a 10% rate of return, then you would pay no more than \$900,000 for the real estate.

$\$90,000 \text{ Net Operating Income (NOI)} \div 10\% \text{ Rate of Return} = \$900,000 \text{ Value}$

If you paid more than \$900,000, then the rate of return would be less than 10%; and if you paid less than \$900,000, the rate of return would be more than 10%.

If you know a property value and know its net operating income (NOI), then you can calculate the rate of return by dividing the income by the value.

## EXAMPLE:

If you have an opportunity to buy real estate, which is priced at \$800,000 and has a net operating income (NOI) of \$90,000, then your rate of return is 10%.

$\$90,000 \text{ Net Operating Income (NOI)} \div \$900,000 \text{ Value} = 10\% \text{ Rate of Return}$

To achieve a rate of return higher than 10%, either the price would have to decrease or the Net Operating Income (NOI) would have to increase.

If you know the value and the rate of return desired, you can calculate how much Net Operating Income (NOI) should be produced, by multiplying the value by the desired rate of return.

$\$900,000 \text{ Value} \times 10\% \text{ Rate of Return} = \$90,000 \text{ Income}$

In investment real estate, a capitalization rate is used to estimate a value of a property for a buyer or a seller. Assuming there is a standard value for capitalization rates, a property with a known income would have a market value.

Potential Rental Income  
 - Vacancy  
 = Effective Rental Income  
 + Other Income  
 = Gross Operating Income  
 - Operating Expenses  
 = Net Operating Income (NOI)  
 - Annual Debt Service (ADS)  
 = Cashflow Before Tax (CFBT)

As you can see, net operating income takes into consideration more parts of the cashflow model than potential rental income. The comparison of investment real estate is easier, if we consider all these elements and deal with net operating income. Many appraisers use this measure of income when determining the value of a property.

One weakness in using the capitalization approach is it assumes that the property is purchased on an all-cash basis, meaning there is no debt service. Most investment real

estate is purchased using financing. This changes our calculations, because we are not only concerned with the total price of the property and net operating income, but we are also concerned with our down payment, and the mortgage payments we must make.

## Cash on Cash Return

Cash on Cash Return = Cashflow Before Tax / Initial Investment

The real issue might be how much cashflow is retained by the investor

This rule of thumb takes into consideration all of the elements of our cashflow model, because it deducts the annual debt service from the net operating income. It includes all the elements of our cashflow model.

Potential Rental Income

- Vacancy

= Effective Rental Income

+ Other Income

= Gross Operating Income

- Operating Expenses

= Net Operating Income (NOI)

- Annual Debt Service (ADS)

= Cashflow Before Tax (CFBT)

We can then compare the CFBT to the down payment needed to buy the property to calculate a yield.

Assume that the \$800,000 property with \$80,000 NOI can be purchased with a \$600,000 loan (75% LTV). Further, assume that the payments on the loan are \$66,000 per year. The cashflow the investor receives after all payments are made is \$14,000.

\$80,000 Net Operating Income

Less \$66,000 Annual Debt Service

Equals \$14,000 Cashflow Before Tax

\$14,000 Cashflow Before Tax ÷ \$200,000 Down payment = 7% cash on cash

One weakness is that it is dependent on the specific person or entity that purchases the property.

Using the rules of thumb that have been discussed, these are four ways to determine whether this is the correct property to purchase. Which rule of thumb depends on the particular situation in which you find yourself.

In addition to the shortcomings previously discussed, the most glaring deficiency of all of these rules of thumb is that they ignore the holding period of the investment past the first year. They all help the investor come to some initial valuation based on first-year results of ownership. They make no differentiation as to when the investor will receive the benefit included in the calculation.

## Basic Cashflow Analysis

The value to an investor of any investment is based on the future income stream that investment will produce. Real estate is no exception. The cashflow model is the basis for valuing real estate.

Potential Rental Income  
- Vacancy  
= Effective Rental Income  
+ Other Income  
= Gross Operating Income  
- Operating Expenses  
= Net Operating Income (NOI)

Central to this model is an estimation of the net operating income (NOI). From the NOI, we only have to subtract the annual debt service (ADS) to get the cashflow before tax (CFBT).

Net Operating Income (NOI)  
- Annual Debt Service (ADS)  
= Cashflow Before Tax (CFBT)

In forecasting NOI, we are faced with two separate tasks, which are of equal importance.

First we must project the gross operating income (GOI). To do so, we must project the rental income the property will generate.

COMMERCIAL PROPERTIES

Then we estimate the level of vacancy and credit losses the property will experience. Finally, we estimate the amount of any other income the property might receive. When we have done all that, we can calculate the GOI.

Our second task is to project the level of operating expenses we will incur to operate the property. These expenses refer only to the cash outflow necessary to operate the property.

They do not include non-cash items such as cost recovery.

Using the Property Acquisition Form

The Property Acquisition Form is used to determine how much cash an investor needs; this number will configure the purchase of the property and pay the closing costs required. The Cash Required at Acquisition is the initial amount of cash the investor makes.

<b>Property Acquisition Form</b>			
<b>Cost of Property Acquired</b>			
Price of Property			
+ Closing Costs (0%)			
Total Cost of Property Acquired			
<b>Property Financing</b>			
Bank Loan Principal			
Bank Loan Proceeds			
Total Net Loan Proceeds			
<b>Cash Required at Acquisition</b>			

Using the Annual Property Income Form

At the end of this section, you will find a form, just as above, and you will want to use it as a guideline to help you. Note: There are many versions of this form available to commercial and investment agents, in both hard copy and computer-generated formats. What is important is not which form is used, but rather that the use of this format leads to the correct calculation of the numbers provided.

## CASH FLOW ANALYSIS

### Gross Income:

Est. Annual Gross Income	_____
Other Income	_____
Total Gross Income	_____
Less Vacancy Allowance	_____
Effective Gross Income	_____

### Expenses:

Taxes	_____
Insurance	_____
Water/Sewer	_____
Garbage	_____
Electricity	_____
Licenses	_____
Advertising	_____
Supplies	_____
Maintenance	_____
Lawn	_____
Snow Removal	_____
Pest Control	_____
Management (offsite)	_____
Management (onsite)	_____
Accounting/Legal	_____
Miscellaneous	_____
Gas	_____
Telephone	_____
Pool	_____
Elevator	_____
Replacement Budget	_____
Total Expenses	_____
Net Operating Income	_____

### Debt Service:

1 <sup>st</sup> Mortgage	_____
2 <sup>nd</sup> Mortgage	_____
3 <sup>rd</sup> Mortgage	_____
Total Debt Service	_____

### CASH FLOW:

\_\_\_\_\_

Gross Operating Income

Here is a summary of the first part of a forecast of Net Operating Income:

Potential Rental Income  
- Vacancy and Credit Losses  
= Effective Rental Income  
+ Other Income  
= Gross Operating Income

To project potential rental income, you would do the following:

1. Analyze the existing leases that cover the occupied space in the property.
2. Research market comparables of vacant spaces similar to the current spaces vacant in the property.
3. Survey the current tenants to find out whether they have plans to downsize, expand, or relocate in the near future.
4. Determine whether the current rents in the building are above or below the market rents for available similar vacant space to determine whether the rents being paid are in line with the market.

To estimate vacancy and credit losses, you would do the following:

1. Assemble the vacancy histories for the past several years for similar properties.
2. Analyze the impact of changes in rental rates (up and down) on the vacancy rates.
3. Determine the current supply vs. demand condition for this kind of space.
4. Research the current market trends.
5. Estimate what amount of similar space is projected to become available in the next two years (both under construction and on the drawing boards).

To project sources of other income, you would do the following:

1. Determine whether there is any income that is not associated with the primary purpose of the building, such as freeway billboard signs, which can be rented to advertisers on mini-storage properties, or satellite dishes on the rooftops of office buildings.
2. Look for other opportunities for income that have not been used by the owner.

## Real Estate Taxes

1. Use the assessed valuation of the property and the mill levy.
2. What is the trend in this county?
3. Can the assessor's office give you any idea of future changes affecting your property?

## Operating Expenses

In the course of operating any type of rental real estate, a number of costs are incurred. Some of these are called fixed costs. You still have to pay property taxes and insure the building against fire and liability. Other expenses are called variable costs, because the owner has some control over them. For example, you would not be advertising, buying supplies, or paying a manager if the building were shut down.

Estimating these expenses in advance is a mixed task. You can be very precise in your estimate of property taxes and insurance. Other costs, such as maintenance, are harder to predict with any kind of certainty.

Other owners will try to be more market specific in their forecasts. They will talk to other owners, brokers, property managers, and others, who have current experience at managing properties similar to their own.

Another approach is to obtain estimates from the actual providers of the services, who are going to generate these costs. All of these approaches have validity. Whatever strategy owners use, they must make every effort to be as accurate and objective as possible. You are reminded of the old analysis rule: GIGO – garbage in, garbage out. It is easy to make the bottom line of your projections look good by subjectively understating your operating expense.

Listed below are most of the expense categories that will be relevant to the operation of a property. They are listed in the order in which they occur on the annual property income form.

## Accounting and Legal

1. These costs will be incurred and should be forecast, even if performed by the owner.

2. Check with your attorney for the cost of an eviction because you are certain to have some.

### Advertising, Licenses, Permits

1. Check with the local government for any required licenses.
2. Plan the advertising campaign in advance. Check on rates, cost of signs, and so forth.

### Property Insurance

1. Get proposals from specific providers, being very careful to compare similar coverage.
2. Decide on special coverage such as business interruption insurance.
3. Share the risk by carefully evaluating deductibles against their incremental premiums.

### Property Management

1. Will a professional manager be hired, or will the owner do it?
2. A cost should be projected here even if the owner does the managing. Otherwise, the cashflow projections that result from this forecast will overstate the return generated by the property.
3. If a percentage of the revenue is used as the basis of compensation, be sure it is based on gross operating income. If you base the fee on the potential rental income, then you are not giving the manager any incentive to avoid vacancies and credit losses.

### Repairs and Maintenance

1. Age of the building and amount of deferred maintenance is the key here.
2. It is advisable to get an expert's assessment of the condition of the roof, plumbing, wiring, water heaters, furnaces, air conditioners, and so forth. Most tradesmen will provide this service to become the source for any repairs.
3. Management firms and IREM publications are also good sources of information.

### Supplies

1. Maintenance supplies will be needed no matter who does the work.

### Utilities

1. Get utility company records for the two previous years.
2. Base all projections on a full year's basis. There are wide variations between months depending on the location of the property.
3. Check leases for pass-through provisions or expense stops.

### Miscellaneous

1. All projected expenses not previously allocated.
2. Includes such things as snow removal, pest control, janitorial, and the like.

There are other operating expenses that might become part of your analysis. Examples of these expenses are personal property taxes, payroll, and associated taxes and benefits.

After calculating the operating expenses we are ready to calculate net operating income.

## NET OPERATING INCOME AND CASH ON CASH

Subtracting the total operating expenses from the GOI gives the NOI.

This is the operating result of the property.

As can be seen from a review of the operating expenses, the net operating income (NOI) includes only the results of operating the property. That is why appraisers use this number for their income approach to value.

$$\begin{aligned} \text{Gross Operating Income} &= \\ &\underline{\text{Operating Expenses}} \\ &= \text{Net Operating Income} \\ &\underline{- \text{Annual Debt Service}} \\ &= \text{Cashflow Before Taxes} \end{aligned}$$

The final objective of our analysis is to determine the Cashflow Before Taxes.

Net Operating Income  
- Annual Debt Service  
= Cashflow Before Taxes

The CFBT derived on the Annual Property Income Form will become the input data for the Multiyear Cashflow Form.

We have now completed the entire analysis of the first year of ownership of the property, ending with the calculation of cashflow before taxes (CFBT).

While the annual property income form is a snapshot of one year, a multi-year cashflow view shows a moving picture of the operations of the property. This can be for a five-year analysis, for example.

#### Determining Sales Proceeds

The sales proceeds form is used to determine the expected sales proceeds from a property. It is similar to the seller's net sheet.

Gross Sale Proceeds  
- Costs of sale (commissions, taxes, prorations, etc.)  
- Loan balances  
- Prepayment penalties  
= Net Sales Proceeds

This gives you the sales proceeds before taxes. The sales proceeds before taxes refer to the return of investment dollars, which come back to the investor at the sale of the property.

#### Conclusion

Upon the conclusion of the analysis, the investor or Investor-Agent can determine the cashflows from the acquisition, operations, and disposition of a commercial or investment property. The agent and the investor will then look at these numbers and compare this property with other properties available, making a more informed decision.

# Group Ownership of Commercial and Investment Real Estate

When a residential agent becomes involved with commercial and investment real estate, it is likely that the ownership of the property will be something other than joint or community property. Agents will encounter partnerships, corporations, limited liability companies, and real estate investment trusts. Group investing is a popular alternative way for the ownership of real estate to be held. Groups own a substantial portion of the commercial and investment real estate in the United States. It is important for a real estate agent or broker to be aware of the many facets of group ownership, in order to protect the investors.

In addition, many agents or brokers actually want to be in charge of pooling money from their clients, to form their own groups.

Group investing is often referred to as syndication. The words group investing and syndication are often used interchangeably. A syndicate is defined as a group of people who form an association to undertake a business transaction.

## LEARN HOW GROUP INVESTMENTS OFTEN MEET THE NEED FOR POOLING OF RESOURCES

### Formation

The main reason for forming a group of investors is generally the need to pool the resources of many investors (mostly money) to facilitate the acquisition of equity. Many groups purchase the property for all cash.

## Lack of Available Financing

During the real estate cycle, there is always a time when it is difficult to obtain financing for projects. If the investing world is made up of investors who have 20% equity but the banks are requiring 40% equity, then it will take two investors to complete a purchase of commercial or investment real estate. Forming a group will facilitate the acquisition process.

## Diversification

Another important reason for the forming of groups to buy commercial real estate, is the desire of investors to diversify their investments to minimize risks. Instead of an investor purchasing just one property, a group of investors might purchase more than one property, thereby spreading the risk among multiple properties.

## The Three Areas of Activity in Group Investing

### 1) Acquisition

Real estate brokers or salespeople can become involved in the acquisition of commercial or investment real estate for the group they are forming.

In addition, real estate brokers or salespeople might be involved in working with groups formed by others. Many groups are looking for property to purchase and count on real estate agents to introduce them to properties.

### 2) Management

Real estate brokers or salespeople can become involved in the management of commercial or investment real estate for the group they have formed. In addition, they might work with groups formed by others in the management phase. Many groups are looking for property managers to handle the day-to-day operations of the property they own. The Institute of Real Estate Management (IREM) teaches practical educational courses emphasizing the management skills needed to properly manage commercial or investment real estate for others.

### 3) Disposition

Real estate brokers or salespeople can become involved in the sale of commercial or investment real estate, for the group they have formed.

In addition, real estate brokers or salespeople can be involved in working with groups formed by others. Many groups are looking for real estate professionals to handle the sale of properties their group owns.

When working with properties owned by groups, it is important that brokers or salespeople be certain that the people have the authority to bind the groups into contractual relationships. In residential transactions, it is often taken for granted that the people signing the contracts have the authority, but this is not the case in commercial or investment real estate. The best way to be certain of the authority of the people is to see copies of the documents, which detail the people and the authority to bind the groups to contracts.

## THREE TYPES OF GROUP INVESTMENT OFFERINGS THAT AGENTS MIGHT ENCOUNTER

### Fully Specified

A fully specified syndication is one which is identified prior to any money being raised from the members of the group. Often a fully specified offering is limited to one property. This is the most common type of syndication found in the marketplace. For example, a group formed to raise money to buy a specific apartment building or industrial building, would be considered a fully specified offering.

### Semi-specified

A semi-specified offering is one in which some of the properties are specifically identified, but additional money might be raised from the group members, and the group might buy other properties that become available.

Generally, a semi-specified offering has a specific acquisition strategy to be followed within one property type. For example, a group might have an acquisition strategy to buy a specific office building from a lender. While this is occurring, they simultaneously raise extra money, so the group can buy a second office building from that lender, should another building become available.

A semi-specified offering is usually a larger offering than a specified offering.

## Blind Pool

In a blind pool, there are no properties identified at the time the money is raised from the members of the group. Here, the strategy of the group is to raise all the capital first, and then acquire properties as they become available. Generally, the group will have a strategy, such as buying triple-net-leased industrial buildings in the Silicon Valley, with tenants who have good credit ratings.

Blind pools might be very large in terms of the money raised from the members of the group. Generally these offerings involve many investors, and the offering will not be a private offering.

## DETERMINE OTHER CONSIDERATIONS

### 1. Legal and Security Considerations

When brokers or salespeople become involved with group investing, they enter a new world of additional considerations. You do not need to be afraid of unfamiliar legal and security aspects of group investing, but you do need to know how and when these considerations will affect you.

### 2. The Need for a CPA and Lawyer

Having a CPA who understands real estate and an attorney who understands security laws is mandatory.

### 3. Lending Considerations

Regardless of whether you have a group entity as a buyer, lenders will have specific requirements as to who signs on the loan. This consideration is outside the scope of the group investment discussion, but is an area of which you should be aware.

### 4. IRS Considerations

Many of the side questions regarding group investment might actually deal with the IRS, concerning its rules and regulations. Be certain of which area you are concerned with during your outside questions and research.

### 5. A long-term relationship

Becoming involved in group investments requires a commitment to a long-term relationship with investors.

Investments last several years, and real estate brokers or salespeople must be prepared to be involved with the members. Many groups remain together long after the properties are sold, especially in the case of a group selling the property on an installment sale and holding paper.

Most investment groups' legal documents require two things: 1) to keep financial statements for the six most recent fiscal years; 2) keep the entire books and records for the groups for the current and past three years.

Investors give up direct control of their investment and the properties in which their money is invested. They do not have the same day-to-day involvement they would have if they made a direct investment. As a result, they do not have the same amount of information regarding their investments. Sponsors must communicate with the investors frequently. Some projects – such as construction projects – will demand monthly reports, whereas other projects – such as a single-tenant – net-leased building, might need only semi-annual reports.

In addition to the reporting of the operations of the project, the sponsors must provide annual operational reports and income tax information to the investors.

## LEGAL ENTITIES USED TO FORM GROUP INVESTMENTS

Well, we're almost done and we find ourselves nearly back where we started from! I want to revisit legal entities and perhaps provide a little more insight into the various forms of property and business ownership and their uses.

### GENERAL PARTNERSHIPS OF TWO OR MORE PEOPLE

General partnerships can be formed by as few as two people, with each person being a general partner.

All general partners share equally in management

As a general partner, each person has the ability to take part in the day-to-day management of the properties owned by the partnership. This characteristic is ideal for

a partnership between a lender and a developer formed to develop a particular piece of property. This could be called a joint venture. Each party has a particular expertise and brings a different value to the partnership. It makes sense that each partner would be interested in taking part in making the day-to-day management decisions.

### Joint and Several Liability

As general partners, each partner is totally liable for all the debts of the partnership regardless of the amount of money each partner invests in the partnership.

For example, assume that in a general partnership, one partner invests \$500,000 in cash and the other partner invests only \$5,000 cash. But, as an additional contribution, the partner who invests only \$5,000 agrees to oversee the construction of the project and build the property for cost. Each general partner would be totally liable for any and all judgments levied against the property if the project fails. Of course, insurance might be available to protect the partners against various losses, but on any uninsured loss, each partner would be fully liable.

Title to property is held in the name of the partnership

In a general partnership, the title to the property is held by the partnership, not the individual partners. For example A&B Partnership might consist of investor A and B, but the title is held by A&B Partnership. The partnership owns the real estate, and the individual partners have a personal property interest in the partnership.

This becomes an important consideration in certain situations, such as with death or divorce. The asset owned by the investor is really not real estate but an interest in the group. While the real estate has a marketable value, the interest in the group investment might not have the same value. It is possible that the estate of the person who died or the divorced spouse might not be able to sell the property to free up his or her ownership interest. This is another area in which the lack of liquidity in a group investment might be a disadvantage.

Partnership is a tax-reporting entity only; investors get K-1s and pay taxes

The partnership will file a tax return at the end of the year reporting the results of the property operations using federal income tax Form 1065. However, no tax is paid by the partnership.

The partnership will allocate to each partner his or her share of taxable income or loss depending on the formula contained in the partnership agreement. Most formulas call for a pro rata distribution of profits or losses among partners, but there are provisions in the tax code that allow for a disproportionate allocation. Such an allocation might give one partner all of the cashflow and the other partner all of the tax losses. A tax attorney or accountant would be needed to draft such disproportionate allocations.

The individual partners will receive a Schedule K-1 from the partnership reporting their allocation of taxable profit or loss for the year. The information from the Schedule K-1 is then reported on the individual partner's federal tax Form 1040 and might result in an increased or decreased tax liability for the individual partner.

Because of the allocation of income or loss to the individual partner and the resulting reporting of that allocation on the individual's tax return, a general partnership is called a pass-through entity.

## CHARACTERISTICS OF LIMITED PARTNERSHIPS

Two or more investors

A limited partnership must have two or more partners. One partner must be a general partner who manages the partnership and has the authority to bind the partnership. The general partner is willing to assume unlimited liability. The remaining partners are classified as limited partners.

General partner performs all management functions

By definition, a limited partner has limited involvement in the partnership, including limited involvement in property management, leaving all of the management to the general partner. To protect his or her status as a limited partner, the partner must not take any actions that would cause the partner to be reclassified as a general partner.

Limited partners have limited liability

A limited partner is liable only for the money he has at risk. This means that if a limited partner has invested \$5,000, he would lose only that amount in the investment. His liability is limited to his investment.

Some partnerships have provisions for additional investments over and above the original investment. This provision is sometimes called a capital call or an assessment

provision. If a provision such as this were in the partnership agreement, limited partners would also be liable for that amount over and above the initial capital investment.

Even with a capital call or assessment provision, limited partners know at the outset the total extent of their liability.

To maintain the limited liability feature, limited partners must be limited in their involvement in management. They must be passive with regard to their management of the partnership's business. If investors begin to take part in management, they suddenly look like general partners to the IRS and face the potential of losing their protection of limited liability.

Ownership interests are illiquid

Ownership interests in limited partnerships are personal property and not real property, and there is seldom a market for limited partnership interests. Investors in limited partnerships must be prepared to stay in the investment groups until the property investment cycle is completed.

Partnerships file tax reports, but partners get K-1s and pay taxes

Just as in general partnerships, partnerships file an informational return with the IRS and distribute Schedule K-1s to individual limited partners, who then report their share of income or expense on their own tax returns. Limited partnerships are pass-through entities.

Partnerships have limited lives

Limited partnerships have finite lives, meaning that the partnership agreements call for a date on which the partnerships will end. This is different from the lives of corporations, which are infinite.

Limited partners should be certain that the lives of the partnerships are long enough to allow the partnerships to hold the properties a sufficient time and to have sufficient life to allow the partnerships to sell the properties and carry back seller financing for a reasonable number of years.

The partnership holds the title

In limited partnerships, as in general partnerships, titles to the properties are held by the partnerships, not the individual partners. The partnership owns the real estate, and the individual partners have a personal property interest in the partnership.

## LIMITED LIABILITY COMPANY (LLC)

### History

The first limited liability company law was passed in Wyoming in 1978. In 1988, the IRS formally approved this structure, and in 1996, all 50 states had approved legislation that enabled the formation and operation of limited liability companies. The LLC might be formed by only one member. The owners are its members who can manage the entity directly or appoint managers to operate the entity or supervise officers hired to run the day-to-day activities of the entity. The key documents for an LLC are the articles of organization and the operating agreement.

An LLC created under the laws of one state might do business in other states by registering the LLC in each state in which it desires to do business.

Limited liability is available for all members of the group

In a limited liability company, investors are called members, not shareholders or partners. All members can have limited liability whether they are active or passive with regard to their role in management.

This is a major difference between limited partnerships and limited liability companies and allows the members of an LLC to take an active role in the management of the business of the group.

An LLC is a pass-through entity

In a Limited Liability Company, income or losses from the operation of the business are passed directly through to the members of the group without being taxed at the organization level.

There are no restrictions as to members

In limited partnerships and corporations, specifically S corporations, there are restrictions as to who can be a partner or a shareholder. Many of these restrictions are

eliminated in LLCs. For example LLCs have no restrictions against foreign investors being members of the group or against a corporation being a member of a group.

In addition, there are no restrictions as to the number of members in a group or whether a lender to the group could also be a group member.

### Special Allocations

In LLCs, the possibility exists for providing disproportionate allocations, as discussed in the General Partnership section.

### Multiple classes are allowed

In an LLC, there can be multiple classes of investors. One class of investors might be lenders, another class might be equity investors who want a preferred return, and another class might be equity investors who want the tax shelter and appreciation.

For example, a doctor with a small pension fund could invest the pension fund money in a group and take a secured position as a lender. She could then invest her own money and take a fixed portion of the cashflow as a return. She could also bring in other doctors to invest and give them the tax shelter and the remaining cashflow and appreciation. Fewer corporate formalities are required to protect the limited liability of group members

The limited liability available to shareholders in a corporation might be lost if the corporation fails to hold regular meetings or keep an updated set of corporate books. When the corporate formalities are not adhered to, creditors are able to pierce the corporate veil of protection for the shareholders.

In LLCs, the lack of corporate formalities itself will not allow creditors to proceed directly against a group member, bypassing the protection of limited liability.

### Laws differ by state

Many states allow the formation of an LLC with only one member.

Each state has its own rules as to who the members of a group can be and whether there can be multiple classes of members in an LLC.

### Miscellaneous

It is possible that groups such as limited partnerships, general partnerships, and sole proprietors who wish to convert their current entity structure to an LLC might be able to contribute their properties to an LLC on a tax-free basis. However, corporate conversion to an LLC is most likely a taxable event.

In a real estate venture, as well as in any other business venture, seldom is one of the investors willing to assume general liability for all obligations of the business as is required of the general partner in either a general partnership or limited partnership. Of these three pass-through entities, the LLC offers the best protection from liability for the operation of the business.

## CORPORATIONS

This is the typical form of entity used by larger business organizations. A corporation is formed according to the laws of an individual state and might then be registered to do business in any other state.

The shareholders own the corporation. The shareholders elect the directors, who in turn hire the officers of the corporation. The officers run the business on a day-to-day basis.

Generally, the corporate entity is not favored for the ownership of real estate because of the double taxation that exists by virtue of the fact that the corporation must pay taxes on the taxable income generated by the property and the individual shareholder pays taxes on the cashflow distributed as dividends. This double taxation is avoided by the use of a passthrough entity, such as a partnership or an LLC.

In addition, the strict requirements of maintaining corporate formalities or being faced with the loss of limited liability make the corporate structure a difficult one in which to own and operate real estate group ownership.

## REAL ESTATE INVESTMENT TRUSTS (REIT)

This form of group ownership is favored on Wall Street and used in the largest capital formation transactions. It is a specialized area in which special legal and financial consultation must be sought out and obtained. A REIT is actually a corporation to which special rules are applied so that it can avoid taxation at the corporate level. Two of the special rules are that each year the corporation must distribute 95% of the cashflow to

COMMERCIAL PROPERTIES

its shareholders and that there must be at least 100 investors in the REIT within one year of its date of formation.

## Security Regulations

This section is perhaps the most important in terms of keeping you out of trouble and in compliance with the law. Since you've made it this far then you perhaps have been or will be involved in syndication or public offering memorandums. I have been myself and it is a fascinating way to learn, grow, and prosper at a whole new level involving big players in the world of investing.

Consider this. If you could pool funds together from multiple people, use these funds to purchase a lot of real estate, then manage that real estate for a fee and profit as well from commissions earned on the buy side and eventual sell side, would you be a happy camper? Well, that's exactly what I did several years ago. We created a closed end mutual fund involving some sophisticated folks from Wall Street. We sold shares of the fund to investors. We used the capital to acquire a few portfolios of real estate. We sold some of the individual properties to repay some of the investors. And we earned a property management fee for managing the properties in the portfolio. Not a bad day at the office and I learned a ton in the process. Here is some of what you need to know before proceeding.

Many agents or brokers who are interested in forming their own groups to buy investment or commercial real estate will be surprised to know that what they are getting involved in is the sale of a security, not the sale of real estate. The area of securities laws is vast, and the material presented here is only to alert you to this new area of business and to warn you to get professional advice from a securities lawyer. Be certain to understand that the securities laws may apply even when you are pooling money from family and friends to purchase a single family house as a rental.

In a historic court case in the 1930s, the courts identified four characteristics of an investment in real estate that determine whether the investment is considered a security and therefore comes under the rules and regulations of the security industry.

In this case, it was determined that a citrus grove owner in Florida who was selling ownership in the land of his citrus grove was not selling real estate but was actually selling a security because his investors invested with the expectation of earning a return on their investment based on the profitable operation of the citrus grove.

In this case, the investors actually bought parcels of land, as small as a quarter of an acre, in a very large citrus farm in Florida. When they were presented with a chance to buy a parcel of land they were told that the operator of the farms would handle all the production of the citrus products developed from the farm and split the profits with the land owners.

The citrus grove ran into bad times and failed. The individual property owners stopped paying on their land purchase contracts. They were foreclosed upon, but the property owners sued the owners of the citrus grove saying that they really had not been sold land, but sold a security. The case went to court and was finally settled by the Supreme Court, when it set a four-prong test for the definition of a security.

## ELEMENTS OF THE DEFINITION OF A SECURITY

To be considered a security, an investment must be deemed to have all four of the following characteristics: Investment of Money, In a Common Enterprise, With Expectation of Profit, and Solely from the Efforts of a Third-Party Promoter.

### Investment of money

The investor must invest money into the investment or contribute property that has a monetary value. This characteristic does not include the contribution of labor to a group.

### In a common enterprise

The investment of money must be made into an enterprise that owns the property. The entity must be some sort of group investment with more than one investor. There is no requirement as to which ownership entity must be used because the grouping of investors together makes it an enterprise for the purpose of this definition. The enterprise might be a partnership, an LLC, a corporation, or a REIT.

### With expectation of profit

The investment must have been made with the expectation that a profit would be made on the investment. If there is no expectation of a profit, the money invested in the group could be considered either a gift or a loan because the loan repayment would be made of principal and interest. In securities law, interest is not considered profit. Of course, a gift need not be paid back at all.

Solely from the efforts of a third-party promoter

This characteristic refers to whether there is someone whose actions will determine the financial outcome of the investment and the financial return to the members of the group.

#### COMMERCIAL PROPERTIES

In the citrus farm case, the Court determined that, even though the investment was land, the land owners invested their money in the common enterprise of the citrus farm where they expected to make a profit, but the profit they expected had to come as a result of the owner of the citrus farm, not through their own efforts.

Is There an Exception When Dealing with Family and Friends?

Many times agents ask if there is an exception to the securities laws when they are only dealing with family and very close friends. The answer is that there is not any such exception for family and friends.

Is a loan a security?

Actually a note is a security, but most states have their own law relating to making loans that take the loan out of the definition of a security. However, the agent must be careful when putting multiple investors into one loan. Legal council must be consulted as both the federal and state laws have something to say about this type of pooling of investors' money

Is a timeshare a security?

When an investor buys an individual unit in a timeshare or vacation condo, the investment might be considered more than a real estate investment in the situation where the unit must be part of a rental pool, managed by a management firm. If the buyer was induced to invest their money and buy the property based on the income to be generated by the management company's renting out the owner's unit along with

the other units, the investment might actually be a security. Most states have recognized this problem and have taken control of the timeshare industry in state specific legislation.

## PURPOSE OF FEDERAL SECURITY REGULATIONS

### Regulate the Security

Based on the amounts of money lost in the financial industry crash in the 1930s, the federal government passed legislation to protect investors. This legislation is the basis for the security laws we have today.

The federal laws that regulate the security (The Securities Act of 1933) regulate the paper, or the security itself. The laws state exactly what the security can be and require registration of the security with the federal government. The basic premise of this regulation is that investors are given all the information they need to make informed decisions before they invest.

### Consult Your Broker and a Securities Attorney

As many real estate brokers do not want their agent working in the securities area, the agent should consult with their broker before pooling money from investors. Because a person must follow the laws dealing with offering a security, you should also consult a securities lawyer.

Just as you must have a real estate license to sell someone else's real estate, you must have a securities license to sell someone else's securities. You may be able to sell your own securities without a securities license, but you should consult a securities attorney before starting.

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## Conclusion

I've always loved working with entrepreneurs – often business owners who have a passion for what they do. Real estate investors and Investor-Agents are in fact entrepreneurs. They possess naturally, or develop through education, information, and taking action the character traits of persistence, dogged determination, passion, perseverance, ambition, courage, discipline, a positive outlook, a positive attitude, thick skin, and many other traits but most of all the desire to be free. I mean really FREE. Did you ever dream of flying when you were a kid? That's your spirit calling out to be FREE. That spirit is still within you today. It will never die. In spite of life's circumstances and the efforts of society to make you conform remember this: you are still that little kid and you are going to be FREE. I'm going to help you achieve this.

When I was a little boy I used to get strep throat so bad my trachea would close up and I couldn't breathe. At first I didn't panic because I would knock on the wall next to my bed and Mom would come in and get me breathing again. When I was 10 years old, I contracted strep again but Mom had to go to school for a parent teacher conference with my sister's teachers. She told me that if I couldn't breathe to not panic... and go to the bathroom and use the medicine I had to help me breathe again.

While she was gone my trachea closed up and I panicked. I collapsed in the hall trying to get to the bathroom. I know what it's like to want to breathe and not be able to. I don't know if I can describe in words what that feels like. Thankfully, I eventually grew up and never had strep again.

Later in life I broke my back in two places and couldn't walk. I remembered what it felt like as a child to not be able to breathe. As an adult I had to summon the courage to take action, to learn all I could, and do everything I could to be able to walk again.

I also learned one of the most valuable lessons of my life. After I surrendered to God my challenges and my ambitions, to live by faith and be grateful for everything (and I do mean everything, good and bad), I did everything in my power to do my part to be whole again.

It occurred to me that I was capable of tremendous effort beyond what I had previously known and if I could summon the will to act in times of crisis, why couldn't I summon the will to do this on any given day?

Well I can, and so can you. I live life this way every day. Some people think I am a super human because of all I do. I'm not. I'm Gary Wilson. I have the same number of bones and muscles as you. My brain is the same size as yours. I pray you don't have to experience the same trials that I've had but I know you will experience trials in your own life. I also know you will be tested. Let me ask you, if you can rise to the occasion in times of need... can you, will you, rise to the occasion every single day of your life?

Before we both continue with our life's journey I want to revisit the Wheel of Fortune I put at the end of the "Investor-Agent: Make More Money Not More Work" section.

Let's make sure you have a plan in place now that you are finished reading this book and preparing to turn the last page. When you look at this wheel, you can see that you can enter and begin profiting from a number of starting positions. Let's say you are, or want to start, flipping homes. That section of the wheel is your starting point. But your Path to Profit doesn't end there. It begins there.

At this point you may want to get your real estate license and begin listing and selling your own flips. This way you can start to generate more income in the form of commissions through the use of your license, thereby leveraging what you're already doing to generate multiple streams of income.

Let's say you're buying rentals and managing them yourself. Again, you could begin managing your own properties through an LLC and while you're at it, get your real estate license and manage other people's properties too, generating all that extra income. Starting to get the picture?

Let's say you don't have a dime to your name. You could start wholesaling and generate income that you could then use to do your own investing in rentals or flips.

Let's say you are a real estate agent and you want to start your own investing. Decide what type of investing you want to do first. If you want to flip homes, then work with investors who are flipping homes. You will earn extra commissions (read the section "InvestorAgent: Make More Money Not More Work") and apply those proceeds to doing your own flipping, plus you'll learn more just by being in the flipping game with other investors.

#### CONCLUSION

Maybe you want to own rentals. Well then, start working with investors who invest in rentals. You will earn those commissions, learn a ton and not only start buying your own rentals but start managing them too... for even more income.

Is this making sense? Here again is the wheel. Have a look and start to imagine where you are now and where you want to go on your Path to Profit. Then call me. Email me. Come to one of the Massive Passive Cashflow Method 3-day events. Come see me teach in person at one of the daily classes.

Visit [MyInvestmentServices.com/events](http://MyInvestmentServices.com/events) to see where I'll be teaching. Take one of the training programs associated with any of the five major disciplines in Investment Real Estate. Don't just sit there. DO IT!

# MASSIVE PASSIVE CASH FLOW BLUEPRINT



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## Suggested Reading:

James Allen, *As a Man Thinketh*, Tribeca Books, 2011.

Robert G. Allen, *Creating Wealth: Retire in Ten Years Using Allen's Seven Principles*, Free Press, 2011.

Robert G. Allen, *Nothing Down for the 2000s: Dynamic New Wealth Strategies in Real Estate*, Free Press, 2004.

Rhonda Byrne, *The Secret*, Atria Books, 2006.

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Napoleon Hill and Arthur R. Pell, *Think and Grow Rich*, Tarcher, 2005.

Anthony Hoffman, *How to Negotiate Successfully in Real Estate*, Simon & Schuster, 1984.

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Ron LeGrand, *How to Be a Quick Turn Real Estate Millionaire: Make Fast Cash With No Money, Credit, or Previous Experience*, Kaplan, 2004.

Ron LeGrand, *Ron LeGrand's Cash Flow Systems Course: For Sale By Owner*.  
[www.ronlegrand.com](http://www.ronlegrand.com)

Martin J. Miles, *Vest-Pocket Real Estate Advisor*, Prentice Hall, 1990.

Frank McKinney, *Burst This!: Frank McKinney's Bubble Proof Real Estate Strategies*, HCI, 2009.

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Carleton Sheets, No Down Payment, Home Study Course, <http://www.carletonsheets.com>

Robert Shemin, Secrets of a Millionaire Real Estate Investor, Kaplan Business, 2000.

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# Loan Formulas

## FULLY AMORTIZED LOAN

- In a fully amortized loan, the calculated loan payments will return exactly the lenders' principal over the term of the loan, while simultaneously giving lenders a yield on their investment (the loan) equal to the stated interest rate.
- At the end of a fully amortized loan, the outstanding balance has been reduced to zero.
- In a fixed-rate, fully amortized loan, the amount of the monthly payment will not change during the life of the loan.

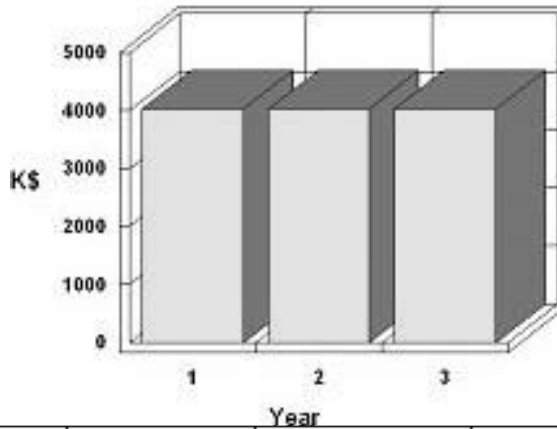
### EXAMPLE:

- A \$10,000 loan, with 10% annual interest and a three-year amortization period, will have three equal annual payments of \$4,021.15. The payments, which include interest and principal, are called debt service.

### **Debt Service Amortized Mortgage**

Year	1	2	3
Debt Service	\$4,021	\$4,021	\$4,021

THE MASSIVE PASSIVE CASHFLOW METHOD



Year	Loan Balance	Interest Payment	Principal Payment	Ending Balance
1	10,000.00	1,000.00	3,021.15	6,978.85
2	6,978.85	697.89	3,323.26	3,655.59
3	3,655.59	365.56	3,655.59	0

Year 1

- \$10,000 loan balance X 10% interest = \$1,000.00 interest due
- \$4,021.15 payment - \$1,000 interest = \$3,021.15 principal
- \$10,000 loan balance - \$3,021.15 principal = \$ 6,978.85 balance

Year 2

- \$6,978.85 loan balance X 10% interest = \$ 697.89 interest due
- \$4,021.15 payment - \$697.89 interest = \$3,323.26 principal
- \$6,978.85 loan balance - \$3,323.26 principal = \$ 3,655.59 balance

Year 3

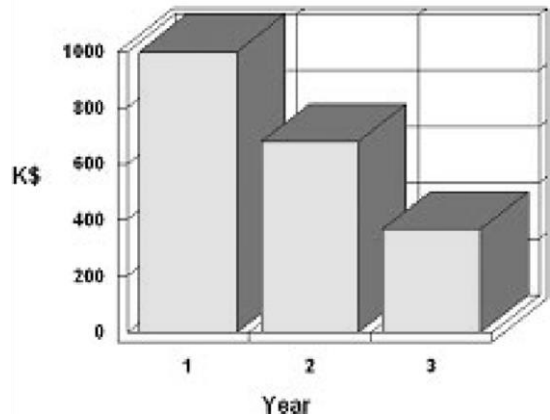
- \$3,655.59 loan balance X 10% interest = \$ 365.56 interest due
- \$4,021.15 payment - \$365.56 interest = \$3,655.59 principal

- $\$3,655.59$  loan balance -  $\$3,655.59$  principal =  $\$ 0$  balance

As you can see below, the interest portion of each payment goes down as the principal gets paid off with each payment. The portion of payment will increase as less of the fixed payment amount is required to pay lenders the interest.

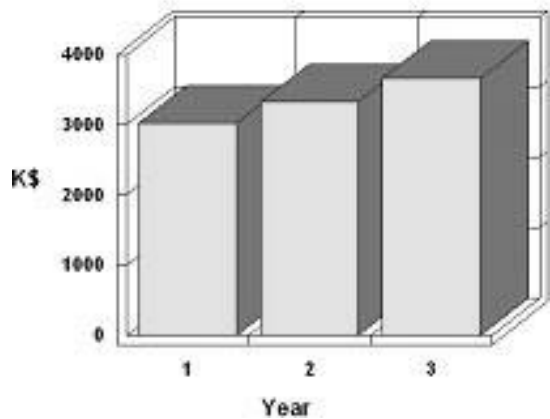
**Loan Interest  
Amortized Mortgage**

Year	1	2	3
Interest	\$1,000	\$1,000	\$1,000



**Loan Principal  
Amortized Mortgage**

Year	1	2	3
Principal Pay Off	\$1,000	\$679	\$366



## INTEREST-ONLY LOAN

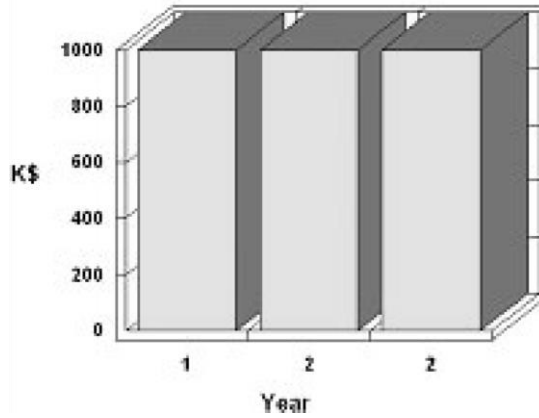
- In an interest-only loan, the periodic payments are just enough to pay the interest, but they are not enough to repay any of the principal.
- As each payment is made, lenders receive a return on the outstanding balance of the loan. The outstanding balance of the loan remains constant. The payment remains the same and as a result, the amount paid toward principal remains at zero.
- At any time, the outstanding balance is equal to the original loan amount.

### EXAMPLE:

- A \$10,000 loan, with annual payments of \$1,000, a three-year term, and a 10% annual interest rate, will not amortize any principal during its term.

**Loan Interest  
Interest Only Loan**

Year	1	2	3
Interest	\$1,000	\$679	\$368



Year	Loan Balance	Interest Payment	Principal Payment	Ending Balance
1	10,000.00	1,000.00	0	10,000.00
2	10,000.00	1,000.00	0	10,000.00
3	10,000.00	1,000.00	0	10,000.00

## WORKING WITH PARTIALLY AMORTIZED AND NEGATIVELY AMORTIZED LOANS

### Partially Amortized Loan

- In a partially amortized loan, the periodic payments are enough to pay the interest, but not enough to completely repay the loan within its term. The term is usually less than the amortization period.
- As each payment is made, lenders receive a return on the outstanding balance of the loan. As the outstanding balance of the loan decreases, the amount paid in interest is reduced. The total payment remains the same, and the amount paid toward the principal increases with each payment.
- Over time, the outstanding balance decreases, but the loan does not last long enough for the entire loan amount to be amortized.
- The amortization period describes the time it would take to repay the entire loan amount. The term is the amount of time the borrower actually has the money. For example “30 years, due in 15” is a term describing a loan with payment amounts set to pay it off in 30 years but that the borrower must pay off at the end of 15 years.

### EXAMPLE:

- A \$10,000 loan, with annual payments of \$4,021.15 and a 10% annual interest rate, will only partially amortize in two years, typically stated as a three-year loan that is due in two years.

Year	Loan Balance	Interest Payment	Principal Payment	Ending Balance
1	10,000.00	1,000.00	3,021.15	6,978.85
2	6,978.85	697.89	6978.85	0
3				

Year 1

- $\$10,000$  loan balance X 10% interest =  $\$1,000.00$  interest due
- $\$4,021.15$  payment -  $\$1,000$  interest =  $\$3,021.15$  principal
- $\$10,000$  loan balance -  $\$3,021.15$  principal =  $\$6,978.85$  balance

Year 2

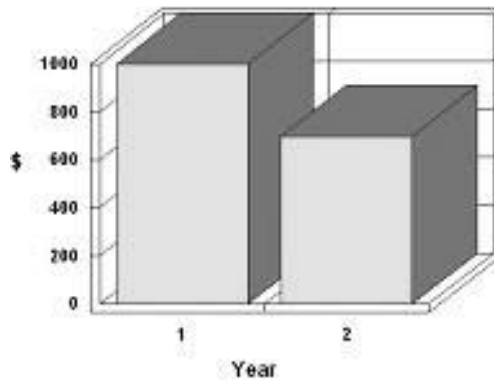
- $\$6,978.85$  loan balance X 10% interest =  $\$697.89$  interest due
- $\$7,675.89$  payment -  $\$697.89$  interest =  $\$6,978.85$  principal

- \$6,978.85 loan balance - \$6,978.85 principal = \$ 0 balance Negatively Amortized Loan

**Interest Detail**

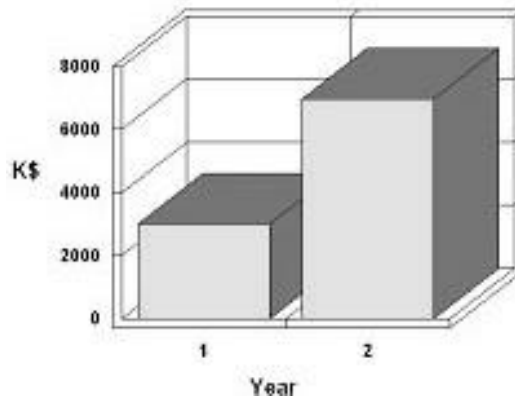
**Partially Amortized Loan**

Year	1	2
Interest	\$1,000	\$698



**Loan Principal Detail**  
**Partially Amortized Loan**

Year	1	2
Principal Pay Off	\$3,012	\$6,978



- In a negatively amortized loan, the payment made is not enough to pay the stated interest rate. In effect, the unpaid interest is an extra new loan each time a payment is made.
- The unpaid interest is added to the loan balance at each payment period.

EXAMPLE:

- A \$10,000 loan, with no payments required and a 10% annual interest rate.

Year	Loan Balance	Interest Payment	Principal Payment	Ending Balance
1	10,000.00	0	0	11,000.00
2	11,000.00	0	0	12,100.00
3	12,100.00	0	0	13,310.00

Year 1

- \$10,000 loan balance X 10% interest = \$1,000 interest due
- \$0 payment
- \$10,000 loan balance + 1,000.00 interest not paid = \$11,000.00 balance

Year 2

- \$11,000 loan balance X 10% interest = \$1,100 interest due
- \$0 payment
- \$11,000 loan balance + \$1,100 interest not paid = \$12,100.00 balance

Year 3

- \$12,100 loan balance X 10% interest = \$1,210 interest due
- \$ 0 payment
- \$12,100 loan balance + \$1,210 interest not paid = \$13,310.00 balance

- When this loan pays off, the \$13,310 balance reflects the repayment of \$10,000 of original loan principal and the \$3,310 of interest added to that original amount.

Lenders are interested in the amount of risk they take when they make a loan. There are several ways lenders attempt to minimize the risk. One way is by making sure the original amount of the loan is less than the value of the property. A second way is to be certain that the amount of income is more than the amount the borrower is required to pay each year.

## LOAN-TO-VALUE RATIO

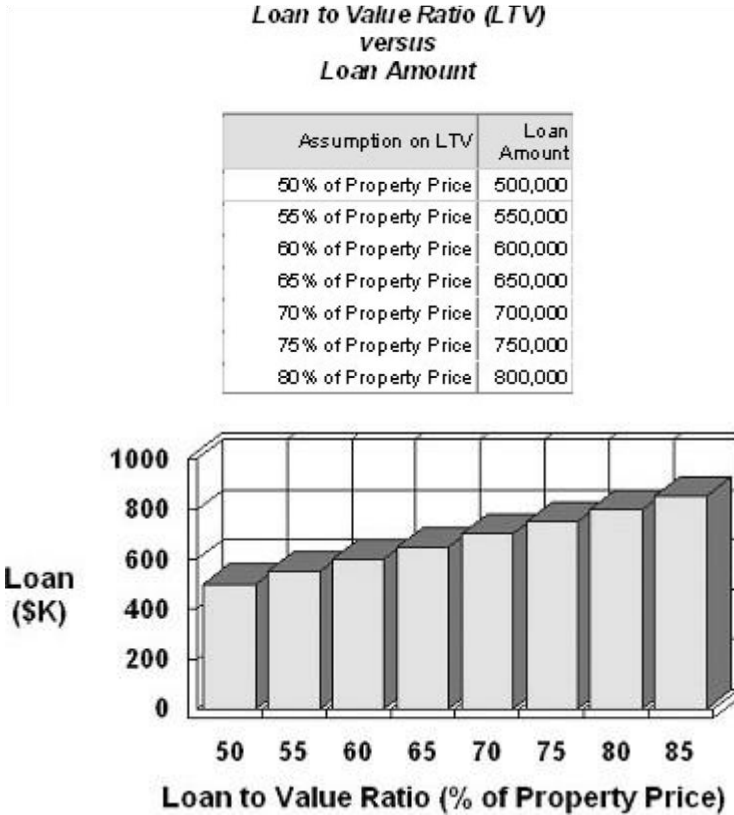
Loan to value (LTV) ratio is the ratio of the loan amount to the value of the property. In investment real estate, it is used the same way as in residential real estate. The use of this ratio allows lenders to determine how much equity there is in the property over and above the amount of financing.

### EXAMPLE:

- A lender has appraised a small office building to have a value of \$1,000,000 and has agreed to make a \$750,000 loan. The loan to value (LTV) ratio has been set at 75%.
- Or, if the lender quotes a loan-to-value (LTV) ratio of 75% and the property has a value of \$1,000,000, the investor can calculate that the maximum loan from this lender will be \$750,000.
- $\$1,000,000 \text{ Property Value} \times 75\% \text{ Loan to Value (LTV)} = \$750,000 \text{ Loan}$

Adjusting the LTV up or down is an approach, which lenders use to adjust for risk in a mortgage investment.

In specific lending marketplaces, lenders' perceptions may be that one product type is riskier than another; lenders may then place an LTV ratio on a new loan, requiring the owner to contribute a larger portion of equity to the acquisition.



### DEBT COVERAGE RATIO (DCR)

The debt coverage ratio (DCR) is the ratio of net operating income (NOI) to the annual debt service (ADS) on the loan. This is the calculation lenders make, when determining whether the property produces enough income to allow the borrower to make the mortgage payments.

$$\text{Debt Coverage Ratio (DCR)} = \frac{\text{Net Operating Income (NOI)}}{\text{Annual Debt Service (ADS)}}$$

EXAMPLE:

□ If the net operating income (NOI) of the property is \$100,000, and the lender states that the annual debt service (ADS) allowed is \$80,000, the debt coverage ratio (DCR) would be stated as 1.25.

$$\frac{\$100,000 \text{ Net Operating Income (NOI)}}{\$ 80,000 \text{ Annual Debt Service (ADS)}} = 1.25 \text{ Debt Coverage Ratio (DCR)}$$

Or, if the lender tells the investor that the DCR will be 1.25 and the investor knows that the NOI is \$100,000, the investor can calculate that the ADS available for mortgage payments would be \$80,000.

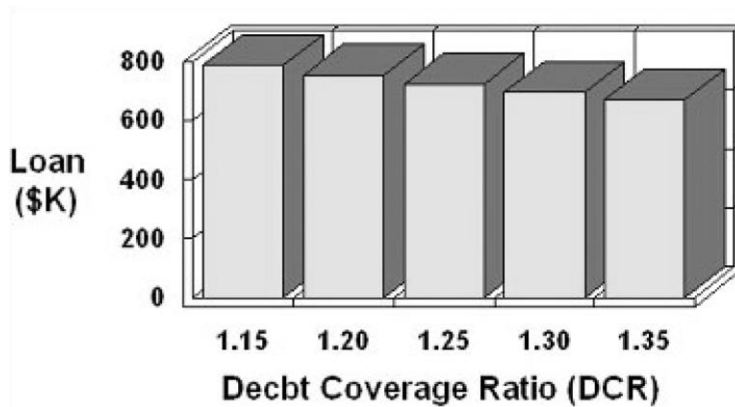
$$\frac{\$100,000 \text{ Net Operating income (NOI)}}{1.25 \text{ Debt Coverage Ratio (DCR)}} = \$80,000 \text{ Annual Debt Service (ADS)}$$

The debt coverage ratio (DCR) is another tool with which lenders attempt to manage risk in an investment in a real estate loan. As the DCR increases, the amount of net operating income (NOI) that can be committed to annual debt service (ADS) decreases. If a lender views the risk in a certain loan, lenders will increase the DCR.

Once the amount of NOI that can be used for payment of ADS is determined, lenders will state the terms of the loan. Of course, the lower the amount allowed for annual debt service, the lower the amount of loan the borrower can acquire.

***Debt Coverage Ratio (DCR)  
versus  
Loan Amount***

Assumption on DCR	Loan Amount
1.1 Times Debt Coverage	863,264
1.15 Times Debt Coverage	825,731
1.2 Times Debt Coverage	791,325
1.25 Times Debt Coverage	759,672
1.3 Times Debt Coverage	730,454
1.35 Times Debt Coverage	703,400
1.4 Times Debt Coverage	678,279



In this chart and graph, it is assumed the loan is 10% interest with monthly payments, amortized over 30 years.

### INTERACTION BETWEEN THE RULES OF THUMB

Lenders use a combination of two rules of thumb discussed above, which determines the loan that will be made on investment real estate. By applying the loan-to-value ratio and the debt coverage ratio, lenders will calculate two maximum loan amounts; then they will make the smaller loan allowed.

#### EXAMPLE 1:

- A retail building is expected to produce \$100,000 of net operating income (NOI) during the first year of ownership and has been appraised at \$1,000,000.
- A lender states that it will make a loan for this property based on lending criteria of a loan-to-value (LTV) ratio of 70% or a debt coverage ratio (DCR) of 1.25, whichever is less.
- The loan is being made at 10%, amortized over 30 years, monthly payments.

#### 1. Calculating the loan amount using the Loan to Value (LTV) approach:

- \$1,000,000 Appraised Value X 70% Loan to Value (LTV) = \$700,000 loan.

2. Calculating the loan amount using the Debt Coverage Ratio (DCR) approach:

- \$100,000 Net Operating income (NOI)
- \_\_\_\_\_ = \$80,000 Annual Debt Service (ADS)
- 1.25 Debt Coverage Ratio (DCR)
- \$80,000 Annual Debt Service / 12 months = \$6,667 in monthly payments
- \$6,667 in monthly payments, with 10% interest, amortized over 30 years will result in a mortgage of \$759,672.

Solution:

1. The Loan to Value Ratio (LTV) approach results in a \$700,000 loan amount.
2. The Debt Coverage Ratio (DCR) approach results in a \$759,672 loan amount.

What will the lender do?

The lender will loan on the smaller of the two loan amounts. In this case, the maximum loan will be \$700,000, determined by the loan to value (LTV) ratio. While the \$6,667 monthly payment can support a loan of \$759,672, the lender's loan requirement is that the loan it makes will not exceed a 70% loan to value. Therefore, the maximum loan is \$700,000.

EXAMPLE 2:

Assume all of the above information stays the same, but the term is now only 20 years. Does the loan amount the lender will give to the investor change?

1. Using the Loan to Value (LTV) approach:

- Using the Loan to Value (LTV) approach the maximum loan will be \$700,000. This remains unchanged.

2. Using the Debt Coverage Ratio (DCR) approach:

- Using the Debt Coverage Ratio (DCR) the maximum loan payments remain at \$6,667. But with a 10% interest rate and a 20-year amortization period, the maximum loan would be \$690,831.

Solution:

1. The loan to value (LTV) ratio approach results in a \$700,000 loan amount.
2. The Debt Coverage Ratio (DCR) approach results in a \$690,831 loan amount.

What will the lender do?

The lender will loan on the smaller of the two loan amounts. In this case, the maximum loan will be \$690,831, which is determined by the debt coverage ratio (DCR) approach. While the lender might make a loan based on a 70% loan to value ratio, the lender has determined that the borrower cannot commit enough of the net operating income (NOI) to make the payments on a loan of \$700,000.

***Loan Debt Coverage Ratio  
versus  
Loan Amount***

Assumption Value	20 Year Loan	30 Year Loan
1.1 Times Debt Coverage	785,035	821,821
1.15 Times Debt Coverage	750,903	786,090
1.2 Times Debt Coverage	719,615	753,336
<b>1.25 Times Debt Coverage</b>	<b>690,831</b>	<b>723,203</b>
1.3 Times Debt Coverage	664,260	695,387
1.35 Times Debt Coverage	639,658	669,632
1.4 Times Debt Coverage	616,813	645,717

As you can see, the loan amounts available for the loan with a shorter term will be lower. With a shorter term, payments will increase to reduce the principal at a faster rate. As

the amount of that debt service dedicated to principal increases, the amount of the available loan decreases.

## Definition of Terms

**Abstract of Title:** A summarized history of the title of real property listing rights and liabilities such as easements, mortgages, liens, and transfers of title. The abstract gives evidence of the chain of title and whether or not the title is clear.

**Acceleration Clause:** A clause in a mortgage that provides, at the option of the lender, the entire unpaid balance of the note would be due immediately upon failure to make a required payment or upon the sale of the property. In the latter case it is known as a due-on-sale acceleration clause. Usually it is found in paragraph 17 of a mortgage.

**Accretion:** The gradual buildup of soil by water.

**Accrued Interest:** Accumulated interest earned or due but not yet paid.

**Acknowledgment:** Legal declaration before a notary or duly authorized officer of a jurisdiction that the one signing an instrument is who he or she claims to be.

**Acre:** A quantity of land equal to 43,560 square feet (for example, a square 208.7' x 208.7' or a rectangle 100' x 436.5').

**Adjusted Cost Basis:** For accounting purposes, the original cost plus improvements minus depreciation or cost recovery taken.

**Ad Valorem:** A measure of worth based on the value of something. For example, real property taxes calculated on the market value of the property.

**After Tax Cashflow:** Effective gross income minus operating expenses and debt service plus or minus any tax savings or tax liability. (Also known as net spendable income.)

#### DEFINITION OF TERMS

**Agency:** A relationship of trust whereby one party, the principal, entrusts another party, the agent, to act in his or her behalf and to represent him or her in doing business with other parties.

**All Inclusive Trust Deed:** The borrower obtains a new mortgage which is structured to include the old mortgage. The borrower makes payments on the new mortgage directly to the lender, who makes payments on the old first mortgage. (Also known as a Wrap-

Around Mortgage.)

**Amortization:** The reduction of debt over a fixed term on an installment basis.

**Amortized Loan:** A loan in which the principal as well as the interest is payable in monthly or other periodic installments over the term of the loan.

**Annuity:** A payment of equal installments paid periodically for a given number of periods.

**Appraisal:** An estimation of value of real property as of the present or past date (not future). Any of three methods are used where applicable: cost approach, income approach, and market data approach.

**Appraiser:** A disinterested party who evaluates a property and determines a value for it.

**Appreciation:** Growth in value.

**Appurtenance:** Anything attached to the land which becomes a part of the property. A fence would be an example.

**Arrears:** The payment of money after the fact. Interest or taxes paid in arrears would represent money paid for a period of time gone by.

**Asking Price:** The price an appraiser has determined for a property and the price for which it is on the market.

**Assessed Value:** The value placed on the property by the taxing body of a county. This value is then used as a basis for computing taxes.

**Assessments:** A tax charge against real property by the taxing body of a county.

**Asset:** Any possession of value that an individual owns which may be used for payment of a debt.

**Assign:** To transfer one's rights in a bond, mortgage, lease, or other legal instrument to another person.

**Assumption of Mortgage:** To expressly take responsibility for the payment of a note secured by an existing mortgage on real property, thereby becoming a co-guarantor of that note.

**Attorney at Law:** A person licensed to practice law.

**Balance Sheet:** A financial statement showing assets, liabilities, and net worth.

**Balloon Payment:** A large final payment due on a note, usually after partial amortization of the debt, through installment payments.

**Bankruptcy:** Proceedings against a debtor, who has been declared legally insolvent, to distribute the debtor's property among the creditors.

**Bill of Sale:** A document used to transfer title to personal property (chattel).

**Bird-Dog:** People who are on the lookout for properties that are for sale. Sometimes they earn a referral fee, if the property is purchased by an investor through their referrals. **Blanket Mortgage:** One mortgage that covers several different parcels of real property.

**Blended Interest Rate:** The interest rate resulting from half the difference of the interest rate originally written for the mortgage and the current market rate of interest. Generally, when loans are not assumable, asking the bank to rewrite the mortgage at a blended interest rate is the next best thing.

**Boiler Plate:** Preprinted sections of a contract.

**Bounds:** Boundaries that are natural (lakes, trees, rocks, etc.) or artificial (roads, railroads, etc.).

#### DEFINITION OF TERMS

**Buyer's Broker:** A broker who represents the buyer when entering a real estate transaction. Generally, the seller pays the broker's commission at the closing.

**Capital:** Money used for investing purposes.

**Capital Gains:** The profits realized above adjusted cost basis on the sale of property.

**Cashflow:** Effective gross income minus operating expenses and debt service. (Also known as cash throw-off.)

**Caveat Emptor:** "Let the buyer beware." This statement does not apply where the buyer and seller are using an agent (broker).

**Chattel:** Personal property.

**Chattel Mortgage:** A mortgage on personal property.

**Closing Date:** A predetermined day that the transaction of buying/selling property will take place.

**Collateral:** Real or personal property pledged as security for repayment of a loan or debt.

**Commission:** Usually a percentage of the purchase price paid to the broker or agent for services rendered.

**Common Law:** Law that is not codified, developed from common usage and custom.

**Competent Party:** A person legally able to contract; being of legal age and sound mind.

**Concessions:** During negotiations, these are the items that each party is willing to give up in order to get the items each party really wants.

**Condemnation:** The process by which property of a private owner is taken, with or without consent, for the public use. Fair compensation must be paid.

**Consideration:** Something of value exchanged by a party to influence another party to enter in a contract.

**Contingency:** A possible event based on the happening of an uncertain future event.

**Contract:** A legal agreement entered by two or more parties which created an agreement to do or not to do something.

**Contract for Deed:** A contract for the sale of real property wherein the seller is obligated to provide a merchantable title after the buyer has paid for the property, usually in installments. (Also known as an Agreement for Deed or Land Contract.)

**Contract for Purchase and Sale:** An agreement between buyer and seller of real property to transfer title to that property at a future time for a specific sum of money. (Also called a sales contract).

**Conveyance:** An instrument (deed) legally sufficient to transfer title to real property.

**Cooperative:** An apartment house or similar property owned, usually in corporate form, by all the tenants. Each has stock in the corporation which owns the building.

**Cost Recovery:** Formerly known as depreciation. A provision of the tax law that allows the owner of real and personal property to recover the cost of that property over a period of time specified by law. Cost recovery may be straight line or accelerated.

**Counter Offer:** A change in price or terms of an unacceptable offer.

**Credit Bureau:** An agency that compiles data on an individual's credit history and, upon request, distributes a report to potential creditors.

**Credit Bureau Report:** The compilation of an individual's credit history. Potential creditors may request a copy from a credit bureau.

**Credit Limit:** Generally found when dealing with credit cards, this is the maximum amount the cardholder may charge to that account.

**Creditor:** The lender. The one to whom the debt is owed.

**Cure Date:** The last day given for bringing mortgage payments current at the beginning of the foreclosure process.

**Dead Asset:** An asset that an investor does not want; in the investor's eyes, it has no value.

#### DEFINITION OF TERMS

**Debt Service:** The sum of the annual principal and interest payments expressed as a percentage of the amount owed.

**Deed:** An instrument conveying title to real property. It usually must be signed by the grantor (seller), witnessed by two persons, and recorded.

**Default:** Failure to discharge a duty or obligation.

**Deficiency Judgment:** A judgment rendered in court for the difference in the amount realized at a foreclosure sale and the amount owed by the mortgagor, if the foreclosure sale fails to completely liquidate or satisfy the debt.

**Depreciation:** (See Cost Recovery)

**Devise:** Disposition of land or real property by will.

**Discount:** The percentage of the original balance of the loan that is charged to the borrower; sometimes referred to as points. Also, the difference between the selling price of a mortgage and the amount due.

**Discounting a Note:** The process of offering a promissory note for less than its face value to enhance marketability.

**Distressed Property:** A bargain property that is substantially below its present or projected renovated value.

**Dower:** The legal rights of a widow in her husband's estate. These rights have been abolished in many states.

**Due on Sale Acceleration Clause:** (See Acceleration Clause)

**Duplex:** A two-family home where the units share a common wall and are situated side by side.

**Earnest Money:** A deposit of money given by a party to bind the contract, usually credited toward the sales price.

**Easement:** An interest held by one party in the real property of another, giving that person the legal rights to trespass on the other's property.

**Effective Gross Income:** The difference between the total gross income and the vacancy allowance.

**Effective Interest:** The interest rate the borrower actually pays as opposed to the nominal interest rate. The effective interest rate is made higher than the nominal rate by addition of points or discounting a loan.

**Eminent Domain:** The power of the government to take private property for public use in return for fair compensation. This power is exercised through condemnation.

**Encroachment:** An infringement, usually an improvement such as a building or fence, constructed on a property contiguous to the one infringing. An encroachment is usually revealed by a survey.

**Encumbrance:** A limitation on the title to real property. A mortgage or easements are examples of encumbrances.

**Equity:** In real estate, the value of an interest a person holds over and above any mortgages or liens on the property.

**Equity of Redemption:** The rights of a mortgagor (borrower) to buy back a property after a foreclosure sale. While equity of redemption does not exist in some states, in other it extends up to two years.

**Escape Clause:** A clause added to the contract that allows either party the option of exiting the contract; thus, both parties are no longer bound by any contractual obligations.

**Escheat:** The reversion of property to the state when an owner dies with no Will and no known heirs.

**Escrow:** Money or documents held in trust by a neutral third party.

**Estate:** Ownership interest in real property.

**Estate by the Entireties:** Ownership by husband and wife with right of survivorship.

**Estimated Annual Gross Income:** An estimate of the total amount of income one will receive in a period of one year.

#### DEFINITION OF TERMS

**Estoppel Letter:** A letter certifying the exact balance of a mortgage or other loan at a given time.

**Et Al:** And others.

**Et Ux:** And wife.

**Exchange:** The exchange or trade of business property you own for another trade or business property that is like-kind. No taxes are due in such an exchange under a given set of circumstances.

**Exculpatory Clause:** A clause in a contract relieving one of the parties of personal responsibility of liability. In a lease, the landlord is relieved of any responsibility for injury to tenants leasing his or her property. In a mortgage, the mortgagor (borrower) is relieved of any personal liability or deficiency judgment if a deficit occurs at a foreclosure sale.

**Expenses:** The costs of maintenance, repairs, and rental costs that are deducted from a property's gross income.

**Executor:** The administrator of an estate; one who is specified in the Will.

**Extension Clause:** A clause contained within some lease option contracts that provides for the terms under which the contract may be extended.

**Face Value:** In reference to a note, the face value is the full amount for which the note has been written.

**Fair Market Value:** The appraised value of a property as compared with other property values on the market.

**Flipping:** The turnover of property. An investor buys a property to immediately sell it for a profit.

**Fee Simple:** The highest estate in real property; the ownership of real property without reservation or restriction.

**Fiduciary:** An agent in the position of confidence to his principal. Also, a relationship of trust and confidence imposed by law.

**Financial Analysis:** An investor's determination of the value of a property according to his or her specific needs.

**Financial Leverage:** The use of other people's money for investment purposes.

**Financing:** The way in which an investor obtains the capital with which to purchase a property.

**First Deed of Trust:** A deed of trust recorded first. Equivalent to a first mortgage.

**Fixture:** Personal property attached permanently to Real Estate and thus becoming part of it. A built-in oven is an example.

**Flexible Seller:** A seller who is willing to sell property in a non-traditional manner. This person may be flexible in terms, price, or both.

**Forced Sale:** The sale of a property used as a security for a loan in order to repay creditor(s) in the event of a default on the loan.

**Foreclosure:** The process whereby property pledged as security on a note is sold under court order because of default on the note.

**Front Foot:** The width of a lot at the front, usually given as the first measurement. (A lot 225' x 175' would have 225 front feet.)

**General Partnership:** A form of business where two or more persons enter into an agreement to conduct business. Profits and losses are shared in a predetermined fashion and all partners are jointly and severally liable for debts of the general partnership.

**Grandfather Clause:** Properties that do not conform to current ordinances, codes, or regulations, but are allowed to continue to be occupied because the properties predate the institution of the ordinances, codes, and regulations.

**Grantee:** A person obtaining title to real property by deed. The purchaser to whom the grant is made.

**Grantor:** One who conveys title to property by deed.

**Gross Income:** The total income from a property before the deduction of expenses.

#### DEFINITION OF TERMS

**Gross Income Multiplier:** That number which, when multiplied times the gross income, would give an indication of property value. It is strictly a guide and frequently abused.

**Homestead Exemption:** Protection extended by law preventing the forced sale of an owner-occupied dwelling by certain creditors.

**Homestead Tax Exemption:** The credit against taxes, given in some states, to a person who owns and occupies a dwelling and to certain other individuals including disabled Veterans, those over age 65, widowed, or handicapped.

**Improvement:** Buildings or other structures which become part of the land are known as improvements.

**Indenture:** A contract.

**Installment Loan:** A loan that must be repaid in no less than two payments. A loan of six months or greater is preferable when establishing credit.

**Installment Note:** A note which specifies how mortgage payments will be made, when they will be due, and for what amount.

**Installment Sale:** A sale which, for income and tax purposes, is not taxed totally in the first year of the sale. To be valid, there must be a minimum of two installment payments over two tax years.

**Interest Rate:** An amount a borrower must repay in addition to the full amount of the loan. This is the premium the lender receives for the use of the money, plus compensation for the risk the lender takes in lending money.

**Intestate:** A person who has died without leaving a valid will.

**Involuntary Lien:** A lien, like real property tax liens, which are recorded against a property without consent of the owner.

**Instant Equity:** The difference between the property's value and what you paid for it.

**Joint Tenancy:** A joint estate whereby upon the death of one joint tenant, his or her interest will go to the surviving joint tenant(s).

**Joint Venture:** An arrangement where two or more individuals or corporations join together on a single project as partners.

**Jointly and Severally:** A legal term indicating that a contract has been entered into by two parties and the two parties are not only liable together but individually as well.

**Leverage:** The borrowing of money in connection with a real estate investment.

**Judgment:** The verdict of a court on a matter presented to it. A money judgment dictates that a party must make payment to another to settle a claim.

**Junior Lien:** A mortgage or other encumbrance with a secondary interest. A lien junior to another mortgage or lien.

**Land Contract:** (See Contract for Deed)

**Land Trust:** A form of ownership whereby property is conveyed to a person or an institution, called a trustee, to be held and administered on behalf of another person called the beneficiary.

**Lease:** A contractual agreement between the owner (lessor) and the tenant (lessee), which allows the tenant use and occupancy of the property for a specified period of time. A lease is an encumbrance against a title and gives the tenant an actual interest in the property, known as an estate, for years.

**Lease Option:** An agreement between two parties where the party who owns the property extends, to the second party, the right to purchase the property at a future date. The second party lives in the property until the lease option expires.

**Leasehold:** The estate of interest held by the lessee in the property of another.

**Legal Description:** The means to identify the exact boundaries of a property. A surveyor will use the recorded plats method, metes and bounds method, or the government survey method to describe the real property.

**Lessee:** One who contracts to hold occupancy rights in the real property of another.

**Letter of Credit:** A letter, usually from a financial institution, guaranteeing (collateralizing) a debt incurred by a third party.

#### DEFINITION OF TERMS

**Letter of Intent:** A letter stating a buyer's intent to make an offer to acquire a certain property. It is not a binding contract.

**Lien:** The right of a creditor to take and/or sell a property in the event of a default to satisfy the obligation of a debt.

**Lien Theory States:** States that allow the lender to collect the debt owed by selling the property in the event of default.

**Limited Partnership:** A partnership composed of a limited partner(s) and a general partner(s). The limited partner(s) contributes capital but is not liable for any debts of the partnership, nor can he or she manage or control the partnership.

**Liquidated Damages:** Damages, usually monetary, spelled out in a contract which would be available in the event of a default, to the party not in default.

**Listing Broker:** A broker from the office which created the MLS listing on a property.

**Marketable Title:** A title free and clear of liens and encumbrances that might be objectionable. (Also known as merchantable title.)

**Mechanics Lien:** A lien right existing in favor of mechanics, suppliers, or other persons who have supplied materials or performed work in connection with the construction or repair of a building or other improvement.

**Metes:** Measures such as inches, feet, yards, or miles.

**Metes and Bounds:** A measure of land which describes the boundaries using metes and bounds. For example, "Then going north 223 feet to the right-of-way of Oak Street."

**Moratorium of Interest:** A time during the term of a loan wherein no payment of interest due is made.

**Mortgage:** A temporary transfer of property to a creditor as collateral for a loan.

**Mortgagee:** A lender of money under the terms of a mortgage.

**Mortgagor:** The borrower, usually the owner, who pledges his or her property to assure performance in repaying the loan.

**Multiple Listing Service:** A multi-realty service whereby members of the local Board of Realtors exchange their listings.

**Negative Cashflow:** When rental and other income is insufficient to cover all the costs of ownership.

**Net Income Approach:** A technique used to evaluate larger properties and determine their values by calculating the net income they produce.

**Net Net Net:** An agreement which specifies that the tenant pays real estate taxes, insurance, and all maintenance costs of the property.

**Net Operating Income:** Gross income minus any operating expenses. Debt service (principal and interest) is not deducted as an expense.

**Net Spendable Income:** Amount remaining after expenses and debt service and any taxes due have been deducted from gross income. (Also known as After Tax Cashflow.)

**No-Doc Loan:** A loan where the borrower is not required to present any documentation to secure a loan.

**Nominal Interest Rate:** The interest rate, usually below market stated on the note.

**Note:** Legal evidence of debt.

**Notarize:** To have a document signed by a notary public.

**One Time Mortgage Insurance Premium:** A refund of a portion of the insurance premiums that have been paid over the years with a 1984 or later mortgage where the mortgage insurance premiums were paid up front.

**Option:** An instrument giving the right of a party to lease or purchase the property over a specified time period for a specified consideration. It is binding for the optionor (seller) but not the optionee (buyer).

**Optionee:** The person who has the legal right to purchase or not to purchase (through a contract) a specific property in the future.

**Optionor:** The seller of a property who extends an option to someone else. If the optionee exercises the option, this person is legally bound by the contractual

#### DEFINITION OF TERMS

obligations. However, if the option is not exercised, then the optionor is released from any responsibilities.

**Owners of Record:** All owners that are listed on a deed that is recorded in the county courthouse.

**Overdraft Protection:** An extra service that most financial institutions offer their checking account clients. The client has a credit limit, much like that of a credit card. If the client writes a check for an amount greater than what is in the checking account, the bank automatically writes the client a "loan." Interest is charged on this, as is an annual fee in some cases.

**Package Mortgage:** A mortgage which, in addition to encumbering real property, also includes personal property such as a refrigerator, dishwasher, or oven unit.

**Partnership:** Two or more people associated for the purposes of carrying on business activities.

**Pay Down:** The amount of principal on a loan retired through payments at a given time.

**Personal Property:** All property other than real property. (It is also known as personality.)

**Points:** See discount.

**Positive Cashflow:** When rental and other income exceed all of the costs of ownership.

**Power of Attorney:** A written authorization to an agent to perform specified acts on behalf of his or her principal. Beyond these acts, the agent has no power.

**Preliminary Title Search:** The first review of all previously recorded documents regarding a specific property, to make sure that the property may be sold.

**Premium:** An additional sum of money paid as an incentive for someone to do something.

**Principal:** The sum of money used as funds for the investment.

**Promissory Note:** Usually a note if given to the seller by the buyer, which promises to pay back principal to the seller. It states the interest rate (if any) and the period of the note.

**Pro Forma Statement:** A financial statement based on anticipated, not actual, income and expenses.

**Promulgated Rate:** A formally and publicly stated rate.

**Pro Rata:** Buyer's and seller's portion of prepaid or unpaid expenses such as real estate taxes.

**Purchases Money Mortgage:** A mortgage given to the seller as part or all of the consideration for the purchase of property. In effect, it is money loaned by the seller to the purchaser.

**Quit Claim Deed:** A deed transferring whatever interest in the property, if any, that the grantor may have. They are usually used to clear title.

**R.E.O. (Real Estate Owned):** Properties that financial institutions have repossessed as a result of a default on a mortgage and which these institutions are willing to sell.

**Real Estate Agent:** A salesperson associated with a broker, who acts on behalf of a broker.

**Realtor:** A broker who is a member of the National Association of Realtors as well as state and local Real Estate boards.

**Recording:** The act of entering, in the public record, any instrument affecting title to real property.

**Redemption:** The buying back of one's own property after a forced court sale. (See Equity of Redemption)

**Release Clause:** A statement in a blanket mortgage that allows a specific described parcel to be released from under the blanket lien after a sum of money is paid.

**Reproduction Cost Analysis:** A technique used to evaluate a property by estimating the cost of building the same or similar structure, adding the cost of land and subtracting an allowance for wear and tear.

#### DEFINITION OF TERMS

**Restrictive Covenant:** A clause in a deed in which there is an agreement between buyer and seller stating certain restraints as to the use of the property.

**Right-of-Way:** An easement on land whereby an owner grants or gives to another the right of passage over his or her land.

**Riparian Rights:** The rights of a land owner to the body of water adjacent to his or her land. In some cases these rights include the land under this water.

**Sales Contract:** (See Contract for Purchase and Sale)

**Sandwich Lease:** While having the option to buy a property, the investor subleases it to gain a positive cashflow.

**Satisfaction of Mortgage:** An instrument filed in the public records which acknowledges payment of an indebtedness secured by a mortgage.

**Security Deposit:** An amount of money paid by a tenant before moving into the premises to cover any damage incurred while living there, or to protect the landlord in the event that the tenant leaves without being current on rent payments. If the tenant is current and the unit only has a normal amount of wear and tear, then the deposit is generally refunded.

**Servicing a Debt:** The act of paying the periodic principal and interest payments on an outstanding debt obligation.

**Specific Performance:** A court order requiring a person to act or do a specific thing that he or she had agreed to do.

**Tax Certifications:** Bond sold to recoup unpaid property taxes by the county in which the property is located. When the property is auctioned, the certificate holders may either use the certificates as money to bid on the property or redeem them for face value plus interest.

**Tax Deductible:** An item that is not taxed.

**Tax Liability:** The amount of money one owes to the government for taxation purposes.

**Tax Shelter:** An income property that generates artificial papers losses, due to depreciation or cost recovery, that are in excess of the income produced by that

property. These artificial losses can be used to offset other taxable income earned by the owners. In general, a tax shelter is any deferral, reduction, or elimination of a tax due.

Tenancy in Common: The ownership of an interest in property by two or more persons. Their ownership interest may be equal or unequal and there is no right of survivorship as with joint tenancy. The interest of any joint owner passes to his or her heirs or assigns after death.

Tenant: A person having the temporary use and occupancy of real property owned by another.

Tender: An offer to pay or perform.

Terms: The exact way a property will be purchased.

Testate: One who dies leaving a Will.

Timeshare: A piece of property purchased by two or more parties who have set specific times when each may use or occupy the property.

Title Insurance: Insurance issued by a title company guaranteeing the title to be good and marketable. Title insurance policies can be issued to protect the mortgagee only, the full interest of the buyers, or both.

Title Insurance Company: A business that reports on the status for the title on a specific property and whether or not it has any liens against it. After this title search has been completed, the company will issue a deed to be signed by all the owners of the property which should be notarized and recorded in the public records.

Title Theory States: States that allow the lender to become the legal owner at the time of making the loan. The borrower only has possession.

Township: A unit of measure used in the government survey method of land description equal to 36 sections (36 square miles).

Unilateral Contract: A contract in which one party is bound by another to do something. If the second party chooses to exercise the contract, the first party must perform any contractual obligations that party may have. However, if the second party

#### DEFINITION OF TERMS

chooses not to exercise the contract, the first party is released from any contractual obligations.

**Unsecured Line of Credit:** A credit history developed by an individual who borrows small amounts of money which do not require collateral.

**Usury:** The lending of money at a rate of interest about the legal rate.

**Vacancy Rate:** An estimate of the amount of time the rental property will be vacant (between tenants) multiplied by the rental rate of the unit(s). The amount is used in estimating the investor's value of an income.

**Value, Assessed:** The value as determined by the local tax assessor's office for the purpose of levying local taxes.

**Value, Book:** The value of a property carried on a company's books. It is usually the cost less depreciation or cost recovery plus capital additions.

**Vendee:** A buyer.

**Vendor:** A seller.

**Warrant:** To guarantee something to be as represented.

**Wrap-around Mortgage:** A mortgage held by the seller-mortgagee. The buyermortgagor pays the seller-mortgagee the debt service on the wrap-around mortgage and the seller-mortgagee continues to pay the debt service on the underlying or original mortgage.

**Zoning:** The laws which regulate and control for what the property may be used.

## About the Author

Gary Wilson has been a Scout Master in Troop 194 of the Greater Pittsburgh Region and involved in scouting for more than a dozen years as an adult and was a scout as a boy.

He started investing in Real Estate at the age of 23, less than one month after graduating from Old Dominion University, and accumulated a 250-unit portfolio while teaching others to do the same.

Gary ranked in the top 5% of all Realtors in the Western Pennsylvania Market (according to annual Five-Star surveys).

He is a licensed broker in Pennsylvania and Virginia. He achieved the Platinum level of service while launching and growing Win Realty Advisors, LLC; Win Rental Management, LLC; and Win Settlement Services, LLC.

Gary has taught in classrooms across the U.S. and Canada to tens of thousands of students and has personally trained thousands of investors and agents who want to realize the pleasure of rental profits without the pain, flipping without the risk, and wholesale for profit so everybody wins.

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