

CHAPTER 1

Why Commercial Real Estate?

Americans work, work, and work. A study by the Economic Policy Institute shows that worker productivity in the United States has risen 33 percent over the past decade (“The State of Working America 2006/2007” by Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto). Yet many Americans have little to show for it. Only a small percentage of people achieve financial independence by the time they retire. The rest spend their retirement years surviving on pensions and Social Security benefits. For younger Americans, even those often-inadequate safety nets are becoming precarious. Increasing numbers of companies are abandoning pension plans as an employee benefit, and the beleaguered Social Security system faces an uncertain future. Because of those realities, people must shift the way they think about the future. They must take the initiative to invest now in order to live the way they want later. Instead of working for their money, their money should be working for them.

Commercial real estate investment is a powerful way to make that happen. And it is easier than you think. In fact, if you can master just half a dozen important keystones to property investment—the Big Six formula—you can put yourself on the road to real estate success.

What you really need as you enter the world of commercial real estate is an understanding of how to make wise investments. This book will help you comprehend the ins and outs of a real estate deal, why finding the right property to buy is the most crucial part of your investment, what the Big Six formula is, and how you can

master its steps. Why real estate is the way to go and why too few people pursue this option is the focus of this chapter.

Real Value, Real Ownership, Real Estate

The goal of real estate investment is to increase your net worth, strengthen your income, and achieve financial independence so that, if you eventually choose, you can stop working and begin living the life of your dreams. Different people have different financial goals. You could aspire to a net worth of several million dollars with a very substantial annual cash flow. Your cash flow is the money remaining in your pocket after deducting operating expenses and mortgage payments from gross rental income. Or your goal may be to achieve a \$1 million net worth with a more modest cash flow. It depends on your particular needs, wants, and circumstances. That said, all investors—regardless of their financial objectives—need to learn the same strategies for identifying and taking advantage of opportunities.

You may already be saying: “I don’t have enough money to invest.” This is a misconception. It’s true that the majority of salaried workers or professionals, whether they make \$50,000 or \$1 million per year, spend most of it. Then-Federal Reserve Chairman Alan Greenspan created a stir when he told Congress that U.S. residents in 2004 saved only about 1 percent of their annual income (“Testimony of the Chairman Alan Greenspan at the Federal Reserve Board’s Semiannual Monetary Policy Report to the Congress” before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, Feb. 16, 2005). Since then, the statistics have become even more alarming. The personal savings rate has fallen below zero. This is the lowest rate since the Great Depression and one of the lowest of any country in the world. (By contrast, the personal savings rate in China is about 30 percent.) The upshot is that Americans live from paycheck to paycheck and borrow—usually with credit cards—to get through tight times.

That may not sound promising for would-be investors seeking to enter the real estate market. But those statistics hide something important: Although savings rates are falling, the net worth of many Americans has been rising, in part because their homes have increased in value and, in some cases, because stock market investments have stabilized. This means that even without savings,

most people have assets that can be turned into cash to get them started investing in real estate. You may have money available without realizing it.

Real estate is not the only place to invest, but it holds advantages over other investments. The stock market is volatile. But the volatility of the market is what brings the biggest return on investment. The higher the volatility, the higher the rewards may be, although the risks are also higher (as is the potential for crushing losses). Many factors come into play in the stock market other than the performance of a corporation. World events can affect the market. Just think of what happened on Wall Street after the 9/11 terrorist attacks or how the market fluctuated wildly during the so-called Asian Crisis of 1987; also consider the more recent turmoil in the Mideast caused by the war in Iraq. One bit of news in one single day, either in this country or anywhere else in the world, can cause havoc in the stock market and horrendous losses. Not so with real estate.

Mutual funds may be promoted as a way to diversify investments and establish a “safe” portfolio. A lone mutual fund may hold securities in hundreds of companies, meaning it is less susceptible to a single company’s problems. The funds may also allow people to begin their investment with as little as \$500. But the value of a mutual fund fluctuates and it has no guaranteed return. Furthermore, because a mutual fund is tied to the performance of the stocks in the fund, it could depreciate in value. At the same time, the fees, sales commissions, and administrative costs for the funds can offset some potential returns.

Bonds, meanwhile, tend to rise and fall less dramatically than stocks. That means they are more stable and carry lower risk, but they also carry a low rate of return. When you invest your money in bonds, it is tied up for a period of time. If you sell a bond before it matures, you may find that it’s worth only what you invested or even less. These disadvantages are not normally associated with commercial real estate investments.

There are other investment vehicles, such as money market funds. They are solid and secure, but they are best used to help investors preserve what they already have, not to grow wealth. Inflation may sometimes even outpace these investments. So that brings us to commercial real estate. It is not without its risks, but if you’re knowledgeable about investing in income properties, you can maximize your return while minimizing your risk. And your

real estate investments, particularly well-researched investments in income-producing properties, can prove impervious to other economic ups and downs.

The Control Factor

One of the strongest arguments in favor of commercial real estate over other investments is that you're able to *control* your own financial destiny. People who invest in stocks think nothing of turning their money over to someone else, then hoping for the best. Mutual funds are also managed by professional portfolio counselors. But with real estate, *you* remain in the driver's seat.

Your control over your investment manifests itself in many ways. For starters, you get to see exactly where your money is going. You can do a physical inspection of the property you're buying—see it, touch it, feel it. You can also judge on your own the value of your investment, negotiating the price of your property both when you buy and when you sell. And you make the important decisions about financing and refinancing, including the terms under which each deal is structured.

Beyond that, you decide who will manage your properties. That's an important advantage over the stock market, where you must trust corporate executives and board members to make decisions in your best interest. And just as you oversee the management of your real estate investment, you're also able to maintain your own books on the investment. As a stockholder, you can see a corporation's quarterly earnings or read through its annual reports, but you won't have open access to the books. With real estate, the books are in your hands.

With this level of control, you can maximize efficiencies. You have the freedom to decide whether, when, and even how improvements and renovations are made. You negotiate the leases to your properties based on your wishes and priorities. And you use your discretion to decide when the time is appropriate to make changes, including rent increases or decreases. This flexibility is important. This is your investment. You should have a say over how it is handled.

Financing Options

When it comes to the array of financing options available, real estate has no competition. Banks, insurance companies, pension funds, and other entities that finance real estate investments offer

a wide range of terms and conditions on their loans. As a result, the opportunities to find something that matches your financial situation are numerous. You don't need volumes of ready cash. There are mortgage loans available that allow you to borrow 80 percent (and in some cases, 90 percent) of the value of a commercial property based on amortization periods of 25—and sometimes 30—years.

Once you begin shopping for loans and comparing the terms offered, you'll see that the differences can be quite amazing. In Chapter 9, we'll explore in depth the strategic importance of how you finance your income-property purchases.

The Leverage Edge

Leverage, one of the most significant advantages of investing in real estate, refers to the practice of using a minimal amount of cash to buy a property while financing the balance for the longest term possible at the lowest available interest rate. Leverage is one of the most important tools in building wealth through investment real estate. For starters, it makes real estate affordable. Most investors couldn't make such a significant investment if they had to come up with all the cash at once. Wealthy real estate moguls know the power of leverage.

And leverage, which is, of course, intrinsically linked to the ability to borrow—or access money that is not your own—carries another important advantage. While interest rates on home mortgages have been low, homebuyers generally have no room to negotiate the amount or the terms of the mortgage. In commercial real estate, negotiating the right loan is part of the deal. Commercial financing is discussed in detail in Chapter 9.

Leverage is an extraordinary tool that exists because lenders believe in the stability of choice income properties. They recognize these properties as solid investments. For investors with a strong credit rating, they are happy to make loans for up to 90 percent of a commercial property's value, provided it is a choice property in a top location. I know of no other investment where you can put in as little cash and get as high a rate of return.

Tax Benefits

Income-producing properties carry special tax advantages. Land is not depreciable, but the buildings that sit on it are. Under the concept of depreciation, the Internal Revenue Service assigns

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a useful life to buildings, 39 years for commercial property and 27.5 years for residential property, including apartment buildings. The assumption is that as buildings get older, they decrease in value each year. But when properly maintained, most buildings actually *increase* in value over time. Depreciation is a bookkeeping expense and not an out-of-pocket expense. Therefore, if you have a net income from a building of \$100,000 and the depreciation is \$30,000, the net income now becomes \$70,000. If you are in the 25 percent tax bracket, you will save \$7,500 in income taxes ($\$30,000 \times 25 \text{ percent} = \$7,500$).

In the foregoing example, you may be able to substantially reduce your taxes on the net income by using a method known as segregated cost depreciation. Under this method, the IRS will permit you, based on a qualified engineering report, to divide the cost of the building into four components. One component would be the building itself (the real estate), based on either a 39-year or a 27.5-year useful life. The other three components can be classified as personal property based on a 6-year life, a 7-year life, or a 15-year life.

Because of the faster tax write-off under the preceding formula, your depreciation reduction would be significantly higher during the initial seven years of ownership using segregated cost depreciation. And that would reduce your income tax obligations dramatically. If you have already invested in real estate and haven't used this method of depreciation, you can go as far back as 1986 and calculate the additional depreciation you could have taken under segregated cost depreciation. You can state it as a deduction on your current income tax return without amending any previous returns. If you are a real estate professional (not necessarily a broker or agent) and active in the operation of the building, you can take any losses generated by depreciation as a deduction against your ordinary income—which lowers the amount of income tax that you pay. The resulting income tax savings would, in effect, increase your cash flow and, accordingly, your cash-on-cash return.

Paul White, a prominent real estate broker and educator in South Florida, states, "One of my clients who acquired 10 properties over the last 12 years was able to reclassify approximately 23 percent of their depreciable value of \$25 million and realize an income tax reduction of over \$1.5 million on their most recent tax return."

Meanwhile, exchanging one investment property for another investment property defers capital gains taxes until a subsequent

property is resold (1031 Exchange). Those are just examples of the many tax benefits that are available on real estate investments. Later, as we explain different financing options and property sales approaches, we'll also discuss their tax advantages.

Access to Information

Real estate is an investment characterized by openness and quick access to information. Real estate sales are part of the public record, so it's easy to track sales histories and the financing details of a particular property. Local and national property listings, sales of tax liens, details on sheriff sales, and foreclosures are among the volumes of information available on the Internet. There are public records on how neighborhoods are zoned, and Census Bureau information details the demographics of different locations. There are simple formulas as well as statistics in trade publications that help determine the annual costs and expenses of a building.

Easy Troubleshooting

One of the other pluses of real estate investment is that when a downturn takes place and some real estate is at a standstill or declining in value, there are still opportunities to make money. For example, you can invest in properties (e.g., medical buildings) that remain profitable despite market forces. Or you can do condo conversions of small apartment buildings in response to market demands. (The process for converting small apartment buildings into condominiums is explained in detail in Chapter 13.) When owners sell properties, for whatever reason, during down markets, they will often agree to deals that they wouldn't otherwise consider. For example, if an owner was selling you a building for \$500,000 but you thought the building was really worth \$525,000, you could ask for a one-year option with an option fee of, let's say, \$5,000. If within six months you then found a buyer willing to pay \$525,000, you could exercise your option and make a \$25,000 profit—on an investment that cost you only \$5,000. In addition, the \$5,000 option money would be credited to the purchase price. In effect, you've engineered a deal that brought you a whopping 500 percent return based on a six-month holding period and an annualized rate of return of 1,000 percent.

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There is a risk, of course. But that risk would be that, if you didn't find a buyer within the prescribed period of time, you would forfeit the \$5,000.

Another opportunity in such a market would be to persuade the seller to finance the deal with 20 percent cash down and to hold an 80 percent mortgage. The chances of the seller doing this in a down market would be much greater than if the market were on the ascent. In obtaining seller financing, you would save a barrel of money because you wouldn't have to pay a bank any points or closing costs.

The lesson here is that real estate is not an either-or investment arena. There are easy formulas and fixes for weathering its ups and downs.

Overcoming Fear

If real estate is such a great investment, why aren't more people investing in it? The answer is simple: Fear gets in their way. Of course, it is normal, particularly for a first-time investor, to be wary. In fact, no investor, whether inexperienced or experienced, is completely immune. Some of these fears may be self-imposed, while others come from external influences. But there's a single antidote for all of them: knowledge. The better you understand the "fear factors," the less intimidated you'll be. Let's explore the principal "fear factors."

No-Money-to-Invest Fear

This may be the biggest obstacle for many would-be investors, but it's also the easiest to overcome. That's because it's an ungrounded fear. Although people may look at their bank account balances and immediately assume they don't have enough to get started in real estate, they're wrong. You don't need a lot of ready cash. That's the joy of income-producing real estate. Besides, you likely have assets that you didn't realize could be turned into the seed money you need to get going. Chapter 4 will help you identify your hidden assets and show how to make them work for you.

Fear of Inexperience

Every real estate investor was inexperienced at some point. That's no reason not to take the first step. One of the best ways to handle this fear is by seeking out a trusted person who has been successful

investing in, say, small apartment buildings. Ask whether he or she would consider letting you become a partner in the next investment. That way you learn the steps involved and get your feet wet while under the guidance of someone who knows the ropes. Once you have a successful deal under your belt, you'll have the confidence—and peace of mind—necessary to invest on your own.

Price Tag Fear

All investors have a moment where they wonder: “Is the price too high?” But you have to step back and ask yourself: “Too high compared to what?”

Price is all relative to the market at the time. There are people who bought their own home 20 years ago for \$20,000 and then sold it for \$350,000. Just because they made a big profit doesn't mean the price had peaked. The new owner might resell the home a year later for \$425,000. The price paid for a property many years ago (even if it was \$100) has no bearing on its value today, even if it sells for \$2 million. If you can buy a property at (or below) market value, then certainly you are not paying too much.

The world is full of people who lament: “I could have bought that property 10 years ago for \$50,000. It's now selling for \$750,000. I could have made a killing if I'd bought it back then.” These are the people who, because of price tag fears, pass up every opportunity. Don't let the same apprehension make you a “coulda', shoulda', woulda'” person. It's not only the price that matters but how smart a deal you make. I'm going to walk you through the steps of how to find investment real estate with the best moneymaking potential and then negotiate the best deal possible. You'll soon realize how unnecessary price tag fear can be.

Fear of Management and Leasing

The thought of managing property scares away some would-be investors. But property management doesn't have to be a headache. In fact, one of the best ways to increase the value of your building is with good management—by structuring the right leases, maximizing income, keeping operating expenses under control, and establishing harmonious relationships with tenants.

Owners often choose to self-manage small buildings. With big buildings, your best bet is to rely on a professional management firm.

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A management company has an incentive to obtain the highest rent possible and keep the building at full occupancy, because the company usually works on a percentage of the gross rental income as well as on a percentage of new leases and renewals. In Chapter 12, we will discuss management and leasing and show how good management can substantially increase your bottom line and free you from the day-to-day operation of your building. In most cases, the cost of using a good management firm will be more than offset by the money the firm saves you.

Fear of an Economic Recession

No one can predict for sure when an up cycle will end and a down cycle will begin. When I refinanced my Kendar Office Building in 1998 for \$3.75 million, the bank got nervous before closing the deal. The senior vice president of the bank said, “You know, Ken, we’re making you this loan with some concern because we believe that prices have peaked.” Since that time, my building has tripled in value and my loan is now only 26.2 percent of today’s value of the property—one of the most conservative loans the bank is carrying on its books.

Smart investors know that there are ways to weather the ups and downs. Even more, there are ways to capitalize if a recession hits. It is a good time to pick up properties at lower prices. When it comes to real estate, it’s easy to ameliorate the effects of a recession. “Good quality income properties in top locations are virtually recession proof,” says David Dabby, a well-known South Florida real estate analyst and consultant.

Fear of Risk

Most people resist change because of the risk they associate with it. They prefer to stay where they’re comfortable. Change brings anxiety. But life is filled with change. When people are familiar with a situation or routine, they do not think about it as risky even if the risk remains. For example, if you work and pay your bills, there’s no risk. Right? But what happens if you lose your job? Risk is always there. Sometimes it’s major, other times it’s minor, but it’s rarely absent.

What you need to recognize is that risk is one thing, but the *fear* of risk is quite another. Letting fear get in the way will cut your

financial rewards. As you move forward with your investment strategy, pay attention to those who have been successful and avoid the naysayers who create false anxieties with tales of doom and gloom. Our goal is to strike a balance between risk and reward.

Lack-of-Information Fear

Some people steer clear of commercial real estate because they think they just don't know enough about it. This book is designed to demystify the property-investment landscape. But there are also other ways to become well informed. If you are just starting out on your investment career, one of the best strategies is to build a relationship with a good mentor. You would be surprised at the number of successful investors willing to share the techniques that have made them wealthy. All you have to do is ask. During my own investment career, only a handful of people have asked how I mastered real estate investment. Yet I would have been happy to talk shop with anyone interested.

Novice investors can also get valuable, unbiased advice from a Counselor of Real Estate (CRE). A CRE is a professional who has an overview of the dynamics of a given marketplace. He or she knows what types of properties and what locations represent a good investment with minimal risk. A CRE is a professional who understands the ins and outs of a successful investment. A CRE will charge a fee for the service, but it will be the best money you've ever spent. Furthermore, there are educational courses and seminars offered by professional real estate associations to provide the remaining nuts and bolts that you need to become a successful investor. In Chapter 2, we'll discuss how and where to find the most valuable courses.

Among investment choices, real estate affords the greatest opportunities for wealth. Financial independence is important. It provides a safety net during personal and business catastrophes, and it means that you can stop working for a salary at the time you determine. Probably the most important reason for financial independence was summarized by Oprah Winfrey: "The real beauty of having material wealth is that you don't have to worry about paying the bills, and you have more energy to be concerned about the things that matter" ("Leadership for the 21st Century," *Newsweek*, Oct. 24, 2005).

Keep in mind, however, that investing in real estate requires research and study. You shouldn't buy a property, even in a top location, unless you know what you are doing. You must be familiar with the market and make comparisons of rents, sales prices, and vacancy factors. You must check out zoning regulations as well as distances to shopping centers, houses of worship, restaurants, and entertainment venues. You have to understand mortgage financing and other factors. You'll also need common sense, persistence, and self-discipline. But once you master those and begin to make real estate investments, your money will be working for you.

The Bottom Line

Since the beginning of recorded history, wealth has almost always been measured by the amount of land a person owns. It defined classes—between royalty and commoners, “the haves” and “the have-nots,” the rich and everyone else. There was even a term for people with investment real estate. They were the “landed class.” Today, things haven't changed all that much. The difference is that in our free market society, by knowing what the rich know, you can apply the same principles to create your own wealth.

No investment is risk free. But real estate holds key advantages over other investment opportunities, including the stock market. One of the most important of these advantages is the ability to make a lot with just a little. If you put 10 percent down on a property and then sell it in a year for 10 percent more than you paid, the math shows that your return is a dramatic 100 percent! No other investment comes with this kind of leverage.

Even investors without piles of ready cash will find a welcome mat when it comes to real estate. The players in the financing game—banks, mortgage companies, and insurance companies—compete for your business. As a result, not only can the terms of a deal be exceptionally attractive, but they can be matched to your financial circumstances and abilities. Think back to what we've just said: You can make a real estate investment with as little as 10 percent down. You won't find options like that when it comes to stocks or bonds. On top of it, you'll enjoy tax benefits.

Some people are scared away from investments because they over-analyze or worry. “Over-analysis can lead to paralysis,” says Sandra Goldstein, past chairperson of the Real Estate Commercial

Alliance of Greater Miami. But commercial real estate is not like other investments. There are numerous—and simple—strategies that can help you ride out the storms. Even more, you can make money in bad times as well as good. As for the other fears that hold back would-be investors, most are unfounded. The trick is to balance risk with reward. If you prepare properly, you'll know how to do that.

Most people dream of living with a financial safety net, of having the money they need to live the way they want. But few realize how close they could be to making that happen. Now that you know it's possible, it's time to walk through the basic steps of real estate investment. That is the focus of Chapter 2.

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