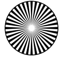

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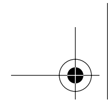
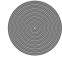
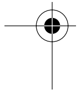
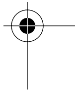

CHAPTER 1

A Portfolio Approach to Investing in Commercial Real Estate

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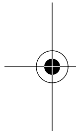
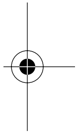
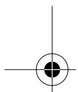
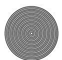
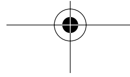
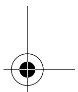
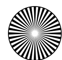
Investing in real estate is not the path to easy riches, but it does provide a path to wealth creation that is surprisingly available to middle and upper income Americans. This path is both available and largely unused. Successful real estate investing is hard work, but it rewards those who are willing to do the work. Many elderly have had a comfortable retirement because of successful real estate investments, many students have gone to college funded by successful real estate investments, and many boats and vacation homes have been financed by real estate investments. Such accomplishments cannot be taken for granted. Successful real estate investors must have the skill, knowledge, and energy to find appropriate properties, evaluate them as investments, arrange for financing, and either manage these properties or find a buyer for them.

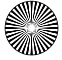



Not surprisingly, many individuals are already into real estate ownership—about two-thirds of Americans own their own home. Even though individuals are primarily motivated to own a home because they need a place to live or like the amenities it offers, homeownership has been a financial boon to many middle-class Americans. Homes constitute the largest and most profitable asset the majority of Americans own. To a considerable extent, the economic benefits of home ownership have been incidental to the home's function as a residence.

This book is about commercial real estate investment. Commercial real estate investment implies investing in real estate for a specific economic end—to make a profit. It does not matter if the property under consideration is a single-family home, a duplex, a condo, an office building or an ice rink. Purchasing such a property to make a profit makes it a commercial activity.



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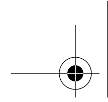
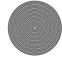
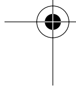
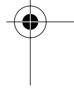
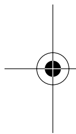
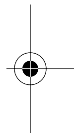





The fact of the matter is that, when many people think about investing today, they think about putting their money into a savings account, buying a CD (certificate of deposit, not the type that plays music), buying some stock, or buying mutual fund shares. That is unfortunate because there is an overlooked world of opportunity in commercial real estate. Most people who could or should be investing in commercial real estate fail to do so because they lack the knowledge of how to do it, feel they do not have the money to do so, or they feel it is strictly an area for professionals. While an individual may lack the knowledge of how to be a successful real estate investor, that can be rectified. The other assertions are not true. You do not need "big bucks" to play in this game and the opportunities are there for all. The only limits are the ones you place on yourself!

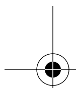
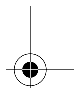
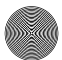
There are many individuals who feel they have managed their portfolios well because they have matched or beat the "market" (the stock market as measured by the Dow Jones Industrial Index or S&P 500). The fallacy in that thinking was revealed when the markets plunged in 2000. Others have experienced first hand the many pitfalls encountered in "playing the market." Solely relying on a strategy of investing in equities as "the" vehicle for wealth creation is a defective strategy because owning different stocks does not mean an individual is diversified. Most stocks are tightly linked to the performance of the overall market. "A falling tide lowers all boats." Such investors would have been much better off had they diversified some of their wealth into real estate.

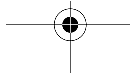
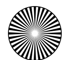



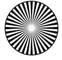
This book is about how to do that. Different sectors of the market are described (not all, but enough to give an investor a flavor of what commercial real estate investing is all about), and illustrations of investing opportunities are offered to prepare readers to evaluate their own opportunities. Working through the material and illustrations in this book will give investors the knowledge that they need to be successful wealth creators.

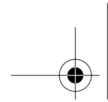
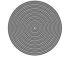
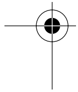
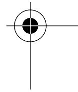
THE HISTORICAL PERFORMANCE OF REAL ESTATE VERSUS STOCKS

The stock market has an excellent public relations team. The drumbeat in the business sections of newspapers, business magazines, and business radio and television shows focuses on stock market performance and the performance of individual stocks. This is because attention to the stock market feeds a $500 billion market composed of stockbrokers, stock brokerages, investment banks, mutual funds, stock market researchers, stock market analysts, stock market writers, and personal financial consultants. This is what they do. They talk and write about

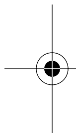
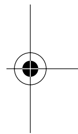





stocks and the stock market. The average investor is exposed to a constant litany of advice and commentary. All this attention creates the impression that stocks are the best way to invest. Even textbooks in personal finance, when they address this issue, present a chart that shows the relative performance over time of a savings account, T-bills, federal long-term bonds, corporate long-term bonds, and the stock market as measured by some broad-based stock index such as the Standard and Poor's 500 or the Dow Jones Industrial Index. The stock market always shows the highest returns that it should because it is the riskiest of all the investment alternatives shown. But where is commercial real estate?

It can be argued that such presentation overstate stock market performance for a number of theoretical and statistical reasons.[1] These reasons include a lack of randomness in the observation, the biases introduced by the selection of arbitrary time periods and the high degree of covariance among individual stocks. While data on the investment performance of specific types of commercial real estate is lacking, considerable work has been done on the performance of publicly listed *Real Estate Investment Trusts* (REITs) relative to home ownership, large stocks, small stocks, international stocks, bonds, and T-bills.[2] The basic findings of this research is that the portfolios of investing homeowners would have benefited from the inclusion of REITs in their portfolios both in terms of higher return and lower volatility (risk.) While there would not necessarily be a correlation between the stock performance of these REITs and a specific commercial real estate investment, such findings are suggestive of the fact that many stock market investors could benefit from diversifying into commercial real estate. In addition, because REITs are freely traded on the major exchanges, they provide the investor with liquidity, a commodity not readily available in other types of real estate ownership.

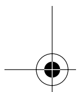
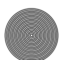



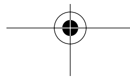
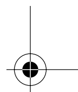
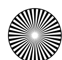
NOW IS THE TIME

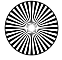
The first decade of the 21st century will prove itself a great time to invest in commercial real estate. Interest rates are at historic lows. Cap-

[1] See http://economymodels.com/stocktime.asp

[2] Jack Goodman, "Homeownership and Investment in Real Estate Stocks," *National Association of Real Estate Investment Trusts*, January 2003; J. K. Brueckner, "Consumption and Investment Motives and the Portfolio Choices of Homeowners," *Journal of Real Estate Finance and Economics*, 15:2, 1997; M. Flavin and T. Yamashita, "Owner-Occupied Housing and the Composition of the Household Portfolio," *American Economic Review*, March 2002.



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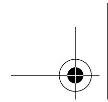
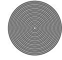
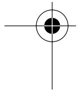
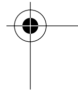
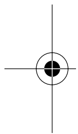
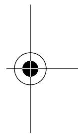





ital is readily available. Inflation is low. The real estate market appears poised for substantial growth. The Jobs and Growth Tax Relief Reconciliation Act of 2003 has created a number of substantial tax advantages for commercial real estate investors. All these factors point to the fact that this is the time to buy. This is a situation that will continue through the end of the decade.

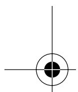
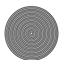
Understanding the commercial real estate market today should begin with an understanding of its historical context. In the late 1980s, a real estate boom was moving toward its peak. Interest rates and inflation were climbing. Real estate was widely seen as a way to "beat inflation." The stock market was in the doldrums. When lenders became overextended and the monetary authorities contracted credit, the market collapsed. This was not a good time to buy. Sophisticated investors were selling, while neophyte investors were buying. By the early 1990s, the real estate market in almost all areas had collapsed. Many commercial real estate developers were bankrupted. A lot of office buildings, hotels, motels, houses, and apartment buildings were sold for pennies on the dollar. Real estate investors were completely discouraged. It was a great time to buy, but it required nerves of steel. Bottoms are hard to see when you are there, just as tops are hard to see just before you go over.

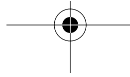
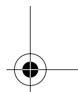
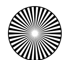
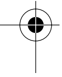



Today's real estate market appears to have moved out of that dismal environment in the mid-1990s and to be on its way to prosperous times. What the future will bring is hard to predict. In the beginning of 2004, interest rates hover near historical lows, stubbornly refusing to rise. Inflation, as measured by the CPI is also low. Capital gains taxes, dividend taxes, and a variety of stimulative tax measures have created greater opportunities for real estate investors. Conditions have been created that favor real estate investing. Certainly, there are no guarantees in this area. Real estate markets have exhibited great volatility in the past and will undoubtedly do so in the future. However, buying real estate now appears to give the wise investor, who has "bought right," the opportunity to gain a foothold for compounding future earnings that constitute the surest form of wealth creation. Buying right requires understanding the basic conditions for success in a particular real estate sector and having the capability of evaluating the financial dynamics of a particular investment opportunity.

The Importance of Location

Real estate properties are differentiated from most other financial or real assets by their uniqueness. No two hotels are exactly alike, no two pieces of undeveloped land are alike, no two office buildings are alike, no two shopping centers are alike, and so on. Commercial real estate is not a commodity. Each property is different because it is in a different

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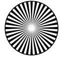
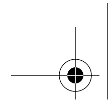
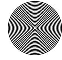
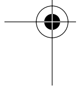
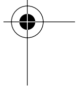
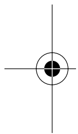
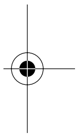


physical location. This makes location one of the most important attributes of any piece of commercial real estate.

The first thing to understand about location is that location is not an absolute. There is no such thing as a generically "good" location (or a generically "bad" location.) The desirability of a particular site is relevant only in terms of its intended purpose. A property that is good for a residential dwelling is not necessarily good for an apartment, an office building, a factory, and the like. Assessing the value of a property always requires the strategic perspective: What is the purpose intended for this property?

Only in that context are the actual physical attributes of that site relevant. Physical attributes of a site would include the current use of the property, its location with respect to traffic patterns, relevant zoning laws, the contour of the land, the attributes and uses of adjacent or neighboring parcels of land (an otherwise desirable piece of land for a single-family residence might be made undesirable if the adjacent property were a mobile home park or a rendering plant), the effective marketing area or impact zone of the property and trends in adjacent, neighbor, local, or regional land use.

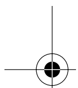
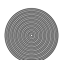



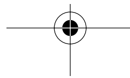
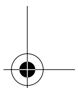
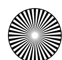
Another factor to consider in the valuation of commercial real estate is the impact of subjective perception. Certainly, a piece of property has an objective reality. However, that objective reality may not be as important as the subjective lens through which that property is viewed. An objective reality might describe 50 acres of rugged land surrounding a dismal swamp located 20 miles from the nearest urban area. A subjective perspective might be to consider land as a nature preserve, featuring select executive home sites surrounding ecologically important wetlands, that provide protection for a living environmental laboratory. The objective reality might be a rundown hotel adjacent to a metropolitan central business district whose desirability is threatened by crime in the neighborhood. The subjective perspective might be that the (refurbished) hotel could become a badly needed retirement community for area residents that is distinguished by its access to urban amenities and its significant architectural and historic significance. An investment in such a property could be thought of as a beacon of successful urban renewal that could revitalize the neighborhood.

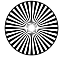
It is all in the perspective. A lot of highly successful commercial real estate development occurs because someone is able to think "outside the box."

The Importance of Diversification

A key to successful investing, in general, is diversification. Specifically, diversification has that wonderful property of lowering risk without nec-



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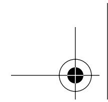
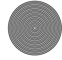
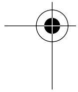
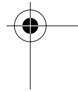
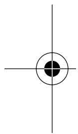
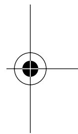





essarily lowering gain (and often raising gain). We argue in this book that most investors should be diversified into real estate. We now wish to argue for diversification within the real estate sector for the same reasons.

In the middle of 1984, the market for office space in the Baltimore–Washington metropolitan area had been moribund for two years, with vacancy rates averaging around 14%. Manekin LLC, a private developer and broker of office buildings was not doing well as a result. Rather than downsize its staff, the organization looked at the residential market that had been red hot the last three years and decided to get into this real estate sector. Richard Alter, Manekin LLC President was quoted as saying, "Going forward, depending on market conditions, we expect to see 40% residential, 50% office, and 10% retail."

Moreover, in this area (as in most metropolitan areas), land for developments of any size was becoming increasingly difficult to find. In addition, local planning and zoning boards were becoming increasingly demanding. It turns out that the trend among these regulators is towards mixed-use development. This makes diversification a natural fit for a company like Manekin.

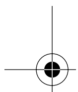
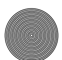
MIE Properties, a real estate development company that is also in the Baltimore–Washington metropolitan area, held about 2 million square feet of office space and 2 million square feet of retail space in 2004 and was in the same boat as Manekin. So, they began developing an 800-unit residential property that had a much brighter profit outlook. "We look at a piece of land and say, 'What would maximize the value?'" said Ed St. John, MIE Properties President. "We're not stuck with what we do. We do it all."

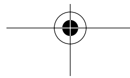
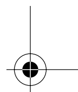
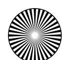
"If one end of the market takes a hit, you have something else to fall back on. It never hurts to be diversified," says J. William Miller Senior V.P. at the commercial real estate firm NAI KLNB.

The Dynamics of Wealth Creation and Preservation

Creating and preserving wealth starts with saving. Sad to say, there is no shortcut here. Those individuals who maxed out their credit cards in 2000 and 2001 to invest in the stock market paid an awful price for trying to go the easy way. Creating wealth is the classic example of the tortoise and the hare. To become wealthy, it is not necessary to make a one-time "killing." A much better approach to creating wealth is to use the power of compound interest.

One dollar invested for 20 years at 4% is equal to $2.19 (double your money), at 6% your money triples to $3.20, at 10% it increases to $6.72, and at 14% your initial investment will grow to a fabulous $13.74. No need to make a killing. All that is needed is patience and a sound investment strategy.

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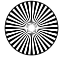
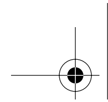
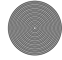
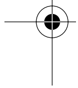
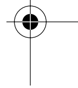
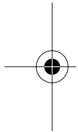
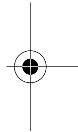


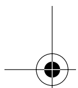
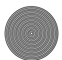
Commercial real estate opportunities offer rates of return that will have big payoffs through the power of compound interest. The trick to remember here is that higher returns go hand-in-hand with higher risk. When you receive an offer to have more return with less risk, watch your wallet and run for cover. Still, opportunities with superior returns relative to the risk abound in today's commercial real estate market and this situation is likely to continue for some time.

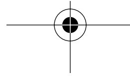
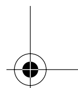
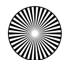
Risk and Danger Are Not the Same

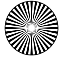
Danger is something to be avoided at all costs. A sign that says "Danger—Unexploded Ordinance" means keep away. Rational individuals do not trespass. Risk is different. Risk needs to be embraced by investors because without risk there is little, if any, return. All forms of investment are risky. Avoiding risk is not the issue. Getting compensated adequately for bearing risk is the issue. All commercial real estate opportunities have risk, just as all other investments have risk. However, as commercial real estate is underused as an investment vehicle, the returns relative to the risk tend to be larger than those available in more traditional investment vehicles. If Prudential Insurance has an AA-credit rating and its 10-year bonds pay 9%, what is wrong with doing a build-to-suit lease for one of their regional offices that looks to earn a return of 22%? In both cases the obligation is secured by the general credit of the corporation. Which is preferable to the knowledgeable investor?

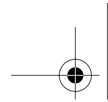
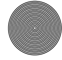
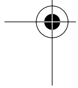
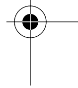



For investors the risk they are exposed to is not simply the sum of the riskiness of all their individual investments. Rather, it is the risk inherent in their entire portfolio. The risk of individual investments is not the same thing as the risk in the portfolio. This is because the risks of the different investments in your portfolio are more or less correlated with the risks of other investments in your portfolio. The effect of diversification among different types of investments is generally to reduce the risk of the overall portfolio without necessarily reducing return. This happens because the individual risk on one element in the portfolio may be largely independent of the risk of another element in your portfolio, so the risk of the portfolio itself declines. A property and casualty company's portfolio of homes they insure for fire hazard may illustrate this concept. If the probability of one home burning down is 0.001 (one in a thousand) and the probability of another home burning down is also 0.001, then the probability of them both burning down is 0.000001 (one in a million.) So adding elements to the portfolio whose risks are independent lowers the risk of the portfolio itself, even though the elements are equally risky.

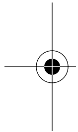
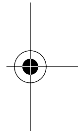


An important implication of this concept is that investors should not evaluate the risk and return on an individual investment in terms of the riskiness of that particular investment alone. Instead, the risk should be judged by the impact of that investment on the riskiness of the overall portfolio itself. This means that it is possible to add a relatively risky investment to a portfolio and have the total riskiness of the portfolio go down. This reflects the way in which the riskiness of that investment is correlated with the riskiness of the existing investments in the portfolio.

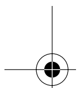
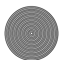
Sometimes what is true for the individual is not true for the whole. Logicians call this phenomenon the "Fallacy of Composition." If it is true that one person at a football game can see better by standing up, it is not true that everyone can see better if they all stand up. It turns out that what is not true for an individual investment—more return with less risk—may be true for your portfolio, that is, it is possible to have more return with less risk because of diversification.

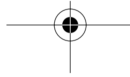
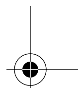
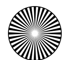
There are a lot of highly technical and mathematical ways to measure risk. All of them suffer from a variety of imperfections. Indeed, they are so mind numbing in their complexity, that the best approach to evaluating risk for the individual investor is common sense.

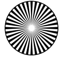



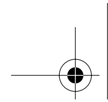
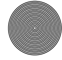
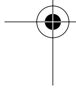
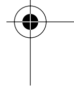
The common sense approach to risk is that while diversification is generally good, it needs to be evaluated within a set of priorities focusing on the life style context of the individual and his or her family. A young family needs to invest in a home and life insurance before they think about stocks. A retired police sergeant and his dependent wife living on his pension have no need to diversify by investing in a risky stock market option. A 45-year-old professional, with a family income of $145,000 a year, a house with substantial equity, and $200,000 in mutual funds as his sole financial asset, should be thinking about getting commercial real estate. Diversification in this case makes sense if the goal is wealth creation.

The whole point of this book is that an upper middle-class individual who today has a good job, is educated, owns a home, has paid off his or her credit card debt, and typically owns a fair amount of individual stocks or mutual funds, can probably stand to diversify into commercial real estate. Such diversification, if done correctly, can increase the individual's overall (portfolio) performance and decrease its risk. However, commercial real estate is not an area to take lightly. Each type of commercial property tends to have unique attributes with which the individual investor should be familiar. Given this knowledge then, a financial analysis of a specific project must be undertaken to figure out exactly what the risk return parameters of the property are. Then, the time comes for the investor to step up to the plate or not, as he or she deems appropriate.



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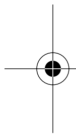
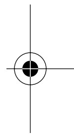
SPECIFIC ADVANTAGES TO INVESTING IN REAL ESTATE

Financial Leverage

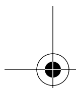
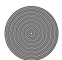
"Give me where to stand, and I will move the earth." said Archimedes, referring to the notion that with a long enough lever he could move the earth itself. The power of leverage is that great. This is as true in finance as it is in physics. Leverage is simply the extent to which debt is used to finance real estate. For example, let us assume that an individual purchases a house for $100,000. If Federal Housing Administration (FHA) financing is available, the owner may put down as little as 5% of the purchase price and borrow the rest ($5,000 equity and a $95,000 mortgage). Now, let us assume that the house rises in value to $110,000. This results in a gain of 10% on the house. By employing leverage, the owner of the house experiences a gain of 200%. This is due to his $5,000 equity investment growing to $15,000. Leverage makes the investor's money work harder.

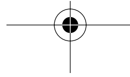
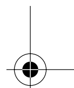
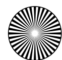
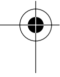



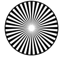
Leverage is not unique to real estate. Stockbrokers typically offer "margin" financing on stocks bought through their brokerage. However, more leverage is generally available for real estate investment. This is because that while the commercial real estate market certainly has its ups and downs, it has nothing like the volatility of the stock market. Lenders feel more secure about their ability to recover their obligations when the value of those obligations is secured by a mortgage to real property whose value stays relatively constant.

Successful real estate investors optimize (not maximize!) their leverage. The general rule is "Borrow to buy, sell for cash." More leverage can make a good investment a great investment. Wise real estate investors generally look for those properties that provide the most financing. That is why single-family residences make such attractive investments. The government, in its desire to encourage home ownership, has created a set of institutions and policies to encourage individuals to purchase homes even with almost nothing down. While such programs are often targeted for the poorest and most disadvantaged in our society, there is a lot of carryover that can benefit almost anyone. Even outside residential properties, an eager seller can be interested in "taking back some paper" to minimize the investor's up-front cash requirements.

To optimize leverage, many investors have a specific strategy that they use in identifying investment opportunities. This involves acquisition strategies that minimize the cash necessary to get into a project and divestiture strategies that look to all cash exits. Such strategies would include minimizing the down payment, borrowing the down payment, extending the life of the loan, and borrowing interest only with a balloon payment for the principal.



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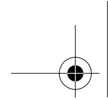
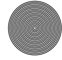
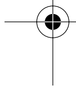
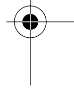
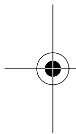
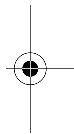





The reason investors want to optimize leverage, rather than maximize it, is that increased leverage brings about increased risk. In this case the additional risk comes from the fixed obligations to pay interest (and perhaps principal.) Real estate investing always involves juxtaposing an uncertain cash flow coming in against a certain cash flow that must be paid out. Where this cash flow coming in is used to fund the cash flow going out (as is usually the case), this raises the possibility that the funds that were supposed to come in do not. This then puts the highly leveraged investor in a hard place. Money can fail to come in because the lessee is unable to pay, an argument with the lessee goes to court (the legal process is unbelievably slow and typically works to the disadvantage of the creditor), or the lessee, for some other reason, does not want to pay. Compelling such a person to pay is typically a long and arduous process, and while this process goes on, no money is coming in. Thus, how much leverage to use is ultimately a decision the investor makes based upon his or her preferred trade-off between risk and return.

Operating Leverage

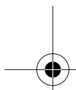
Operating leverage is a characteristic commonly found in real estate properties due to its large proportion of fixed cost to total costs. This characteristic can be described in terms of the relationship between sales volume and profitability of a piece of property. Commercial real estate generally has a large degree of operating leverage due to its fixed costs. When fixed costs are large relative to variable costs, then small increases in sales will generate large increases in profits. The other side of the coin is that large fixed costs require a substantial volume of sales to break even.

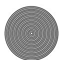
The presence of such operating leverage means that when the revenues are large, the project is wildly successful, but if the revenue is not there, disaster looms. The point about operating leverage is that very small differences in sales can make for very large differences in profits. This makes predicting the failure or success of a real estate project more difficult.

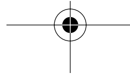
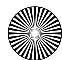
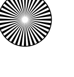
Operating leverage is a form of business risk. Even where the real estate investor intends to take a very passive role in a development as a lessor, he or she is still effectively a partner with the lessee. Where the lessee is successful, the course of the lease will run successfully and both parties will be happy. Where the lessee is unsuccessful, the course of the lease will be troubled and both parties will be unhappy.

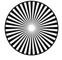
Inflation Resistance

Real estate values tend to rise with inflation. In fact, much real estate often rises faster than inflation because it is in relative limited supply compared to other consumer goods and services. Because real estate







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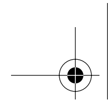
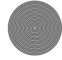
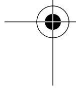
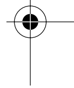
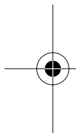
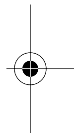





supply tends to be inelastic (insensitive to prices), as demand increases prices will rise faster in this sector.

Of course, a word of caution is necessary. Not all real estate rises in lockstep with inflation. There are variations in the price of real estate between regions, within regions, within states, within cities, and even within neighborhoods. Much depends on location and the demand for property at that location. Great care must be exercised in the selection of specific commercial real estate opportunities.

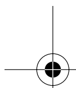
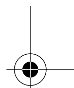
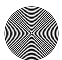



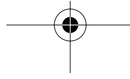
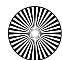
Tax Advantages

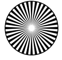
Real estate ownership is encouraged by the tax system. Two important advantages come into play here. The first is interest costs. The second has to do with the concept of depreciation. Both of these factors combine to make real estate investing very attractive.

Interest costs can be fully tax deductible for your personal residence (up to a limit) or for any commercial real estate investment. This means the cost of funds is reduced by your marginal tax rate. As a home owner, if you finance a house at 8% and you are in the 40% tax bracket, your real cost of financing the house will be $8\% \times (1 - 0.4) = 4.8\%$.

The second important tax advantage to owning real estate is the ability to depreciate any property (the buildings, not the land) being rented. Depreciation is a legitimate (noncash) deduction used to offset revenue that would otherwise be subject to taxes. This means you can show a loss on your real estate investment, use that loss to reduce your personal income, and thus lower your taxes. Anything to do with taxes tends to be a bit tricky and depreciation is no exception. Real estate rental is considered a passive activity and losses from a passive activity can only be used to offset passive income (not wages and salaries). However, if an individual actively participates in managing the rental property (as evidenced by selecting tenants, collecting rents, visiting the property, and doing maintenance—all of which are tax deductible in themselves), then the individual may deduct up to $25,000 from earned income, provided he or she does not have adjusted gross income in excess of $100,000 when the amount of loss that can be deducted is phased down to where adjusted gross income reaches $150,000 and no loss at all may be applied to earned income. There are a number of other constraints here having to do with marital status, and the like. There is also something called an *Alternative Minimum Tax* (ATM) to consider. An investor needs to consult with a tax professional to see how he or she may be impacted by the tax code. If an investor can write off $25,000 of paper losses due to depreciation and is in the 40% tax bracket, then he or she will receive a tax saving—a bottom line—of $10,000 in real dollars.



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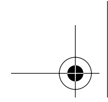
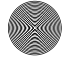
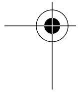
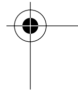
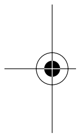
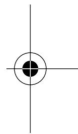





Investing in Real Estate Is Like Owning Your Own Business

Many individuals want to gain more "control" over their lives. The regimen of working for someone else, taking orders, and being subject to an array of arbitrary rules may feel stultifying. It is not uncommon for such individuals to want to "start their own business" to gain more control over their lives. For many people, this may not be a practical alternative. However, there may be another path to financial independence. Commercial real estate is an activity you control entirely. You find the opportunities, arrange the financing, bring all the elements together, and create something where there was nothing before. An individual can enter this business starting small and staying small, with the real estate investing being a profitable hobby. As an alternative, an investor can start small and over time, with a few good moves, grow his or her business into a high-paying full-time job.

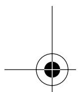
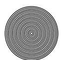
Debt in an Inflationary World Is Good

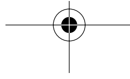
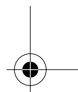
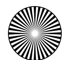



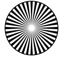
Commercial real estate investors are debtors. They borrow money now to pay it back later. In an inflationary environment this confers a tremendous advantage to the buyer. In theory, interest rates adjust for the level of inflation by adding an inflation premium to the real rate of interest. In the real world, this adjustment process appears slow and uncertain. There have been a number of times within the past two decades where the rate of inflation exceeded the nominal rate of interest. Monetary history suggests a pattern in the world of modern finance where debtors have benefited from borrowing more valuable dollars and paying back with less valuable dollars.

The value of a dollar (or any unit of currency) is ultimately determined by what it will buy. What it will buy is determined by the price level of goods and services that, in turn, is determined by the demand for and supply of those goods and services. While government statistics show little inflation in the first few years of the decade, these indices do not necessarily reflect the buying pattern of real estate investors. It may be argued that broad-based indices (such as the Consumer Price Index), which rely on fixed market baskets of goods and services really understate the true level of inflation relevant to business decision makers.

There are a number of possible causes of inflation. One of the most common causes of inflation can result from the money supply increasing as a result of increasing government debt. Government debt increases because politicians basically find that, when they vote for benefits for people, they get congratulated for doing a good job by those people affected. When they vote for more taxes, they generally get voted out of office. Therefore, politicians tend to spend more without generating the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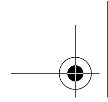
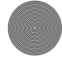
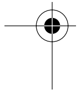
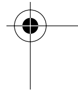
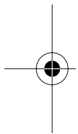
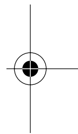


needed tax revenues. The only way that can be done is to create more debt. What is the future for inflation in the United States? The effects of inflation are so powerful and pervasive that economists see inflation as a primary factor in redistributing wealth in our society. The real question is which side of this transfer will you be on?

Compounding Cash Flows

A hallmark of commercial real estate investment is that such investments yield compounding cash flows. Taking advantage of this requires a fairly long-term horizon, but that gets back to the tortoise and hare metaphor. An individual can go to Las Vegas, put down $10,000 on black at a casino roulette table, and double his or her money—or lose it all! The odds are against winning and there is a high degree of risk, but at least the issue is decided quickly. Or an individual can put $10,000 down on a well-located duplex apartment that will earn 21% annually over the next 15 years with very little risk. It takes a long time, but the $10,000 turns into $174,494! This is the miracle of compound interest. In finance, the tortoise not only finishes the race, the tortoise wins the race too! Rabbits show a burst of speed that looks good for a short time, but they rarely finish the race and almost never win the race. Compounding cash flows are the surest way to wealth creation.

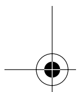
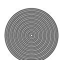
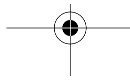
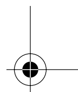
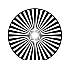


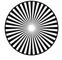
Starting Small

This book is predominantly written for individuals who have already accumulated significant net worth. It is possible that such individuals have overly concentrated their wealth in traditional stocks and bonds and can benefit from diversification into commercial real estate.

What of individuals just beginning the process of wealth accumulation? Individuals whose chief problem is a lack of net worth and, perhaps, even a lack of good credit, are not necessarily left out in the cold. It turns out that real estate offers a great opportunity for such individuals. Social policy in the United States encourages home ownership. This has resulted in financial and banking policies that make acquiring a home relatively easy. This happens because houses can be bought for very little cash up front (many FHA mortgages require as little as 3% equity) and interest payments are subsidized by making them deductible against earned income. Even a person with very little income can enjoy the benefits of financial leverage.

Owning a home financed with a conventional 30-year mortgage have monthly payments that combine the interest owed and equity. The payment on equity is like forced savings. When a house is first purchased, the equity payment is very small but grows larger and larger



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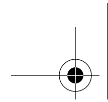
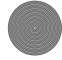
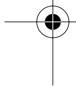
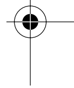
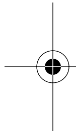
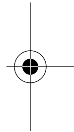





over time—even though the monthly payment is fixed. That equity is actually building wealth. In addition, if the house is well located, it should appreciate over time rather than depreciate. Not only does your wealth increase as the value of the house increases, this gain is likely to be tax-free. Under certain circumstances, capital gains on the sale of a personal residence under $250,000 for an individual (and $500,000 for a couple) are completely free of tax. Even the smallest home owner gets (1) easy access to capital, (2) a subsidized interest rate, (3) forced savings, and (4) wealth appreciation as the house grows in value.

The really good news is that much of these benefits can apply to the purchase of a second (vacation) home. This is a great path to becoming a successful real estate investor. A second home in the mountains, on the coast, or even on a boat (with eating and toilet facilities) can give you a tax deduction for 2004. Mortgage interest on a second home may be deductible if the mortgage does not exceed the fair market value of the home and the mortgages on both your primary residence and the second home do not exceed $1 million. Points paid on the mortgage to acquire the second home may also be deductible if you itemize, but they must be amortized over the life of the loan rather than deducted completely for the year of purchase (as in the case of a personal residence.)

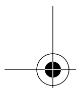
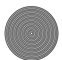
A caveat: Tax law is so complicated and subject to so many special circumstances that one cannot rely on the above generalities. *A tax professional should be consulted prior to making a real estate investment to make certain how the tax laws apply to your particular situation.*

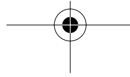
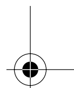
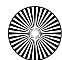
SPECIFIC DISADVANTAGES RELATING TO REAL ESTATE

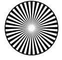
Lack of Liquidity

Liquidity in finance refers to the ability of an asset to be exchanged for cash without loss of value. Publicly traded stocks have good liquidity. (That is the purpose of having "stock markets.") Commercial real estate investments typically do not. If you have invested in a small office building and the time has come to liquidate that investment, it cannot be done overnight, or, at least, it cannot be done overnight without great loss of value.

Of course, much will depend on prevailing supply and demand conditions. It is possible that an investor will decide to liquidate in a period of high demand and short supply. In that case, a sale may be arranged in a few weeks. If the decision is made to liquidate, when market conditions are adverse, then arranging a sale may take months or years.



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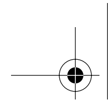
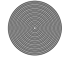
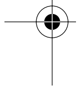
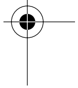
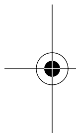
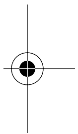





Difficulties in Determining Property Value

This issue is closely related to liquidity. If real estate is inherently illiquid, that means it takes time to realize the property's value. But what is its value anyway? This is certainly an area that it is easy to disagree on.

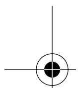
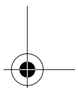
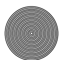
When investors are selling a commercial property, they are really selling a stream of income. Valuing this stream of income requires two factors to be considered. First, one must quantify the stream of income itself, and secondly, one must determine the risk associated with that stream of income.

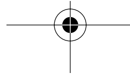
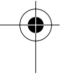
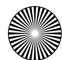
When investors refer to the stream of income, what exactly are they talking about? It is possible that this refers to *net income*. Net income is a residual, resulting from taking all legitimate tax-deductible expenses from revenue and then subtracting the required tax from that sum. This may or may not be a good measure of the property's value. One reason for this is that the calculation of net income results from including, as tax deductible expenses, both business costs and financing costs. While the business costs are likely to remain the same if ownership changes, the financing costs may not. This is because the new owner may use a different capital structure (mix of debt and equity) than the current owner. Thus, net income not only reflects the operating characteristics of the property, but the financial characteristics as well.

As a consequence, some analysts prefer to use *earnings before interest and taxes* (EBIT) as a measure of income. This allows a focus on the purely business aspect of the property. The calculation of EBIT is closely related to that of *net operating profits after taxes* (NOPAT). NOPAT is basically EBIT after taxes. The nature of the tax code is so arbitrary that taxes paid may, or may not, have something to do with firm performance. Using EBIT is preferable in measuring income in situations where the tax is going to be determined by considerations other than those pertaining to the property. NOPAT is preferable if the tax liability is systematically related to firm performance.

Another problem with net income is that depreciation expense, one of the legally permitted deductions from revenue, is not a "cash" expense. Indeed, it is not paid to anyone but merely serves as a device to shelter income from taxes. The property owner retains this portion of revenues. As such, the sum of net income and depreciation is typically referred to cash flow. Cash flow is probably the most commonly used measure of income after net income. Cash flow should probably be used more commonly than net income as a measure of income because it makes greater economic sense. The reason that net income is more commonly used as a measure of income than cash flow is because real estate value is most commonly expressed in terms of income multiples. For example, it is very common to

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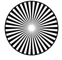
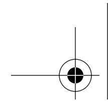
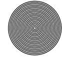
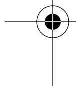
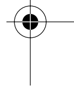
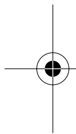
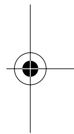


say, “That type of business will sell for five times earnings.” Thus, net income is the traditional measure of earnings in the real estate business.

Yet another measure of income is possible. Real estate properties frequently require regular maintenance to preserve their value. Painting, patching, repairing, clearing drains, replacing worn elevator parts, and so on. The nature of these expenditures is that they may be deferred. While this may lead to a long-term deterioration of the property, such deference will have the effect of reducing the tax-deductible expenses and thus result in a larger net income figure. Consequently, some analysts prefer to take cash flow and deduct necessary maintenance expenses from it. This is a great concept, but in practice it is very hard to identify necessary maintenance expenditures. When this is done, however, such a measure of income is called *free cash flow.*

An additional issue with respect to income is its level. We generally know a lot about income in the present, but less about income in the future. When it is said that the value of the property depends on the income it can generate the reference is to income now and in the future. In many situations, future income can reasonably be expected to grow. In some circumstances, decline is possible. The future level of income can be a very important element in determining income.

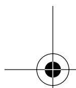
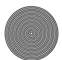
The second element (after determining income) in determining value is determining the risk associated with that value. This risk has to do with the fact that the income anticipated might not occur, or its value may in some sense be diminished. The use of a discount factor is commonly used to adjust the cash flows to take this into account. Thus, discounting that income to its present value explicitly quantifies the risk associated with income.

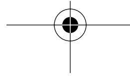
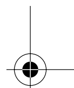
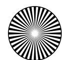
If a property is generating an income stream of $10,000 per year, and that condition is expected to persist for the foreseeable future and a discount factor of 20% is considered appropriate to the risk level of that income, then the value of that property may be determined by the following equation (where n is any number of periods of time):

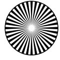
$$\text{Value} = \$10{,}000_1/(1 + 0.2)^1 + \$10{,}000_2/(1 + 0.2)^2 + \ldots + \$10{,}000_n/(1 + 0.2)^n \quad (1.1)$$

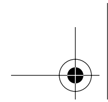
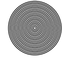
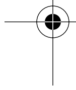
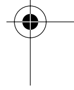
$$\text{Value} = \$10{,}000/0.2 = (5)\$10{,}000 = \$50{,}000 \quad (1.2)$$

Equation (1.1) says that the value of the property is the present value of its income (however measured) discounted at a rate of 20%. (Stated in real estate lingo “its value is equal to five times earnings.”) This is the general rule for determining the value of every kind of com-



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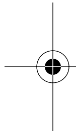
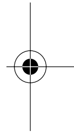
mercial real estate property. That is, ultimately its future earnings and its corresponding risks determine real estate's value. In this case the income level is determined to be $10,000 and those earnings in the future are discounted at an annual rate of 20%. The exponential in this series allows for the compounding effect to take place.

Where disagreements over value take place (and divergent opinions are common in this area), those disagreements center either on the quantity of earnings or the riskiness of those earnings. That is, whether this property is really generating $10,000 in income, or whether there is another way to look at it. Where the buyers and sellers forecast of future earning differ, each will arrive at different valuations. Furthermore, perhaps the seller is basing his analysis on cash flow, while the buyer thinks the net income figure would be more appropriate.

The future is always hard to predict. One way to deal with the risk of the unknown is to increase the discount rate to reflect that risk. A seller might be offering the property for the $50,000, as shown in equation (1.2), because he or she has confidence in the future ability of the property to generate that $10,000 year after year. Potential buyers may not share that confidence. For example, potential buyers may know less about the property and thus, may have less confidence in the property's ability to generate income in the future. Thus, prospective buyers might want to discount that $10,000 at a higher rate, say 40%, to compensate for that uncertainty. Therefore, these buyers will offer to buy the property at 2.5 (1/0.4) times earnings. When market conditions deteriorate, buyers become increasingly fearful of what the future might bring. They respond by seeing the real estate as deserving of higher discount rates. That is why prices fall on the downside of the market.

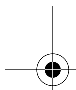
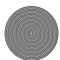



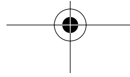
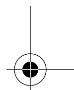
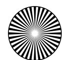
Another variation of equation (1.1) commonly encountered is where future income is likely to grow. (In equation (1.1), future income was projected to be constant.). This situation is expressed in equation (1.3).

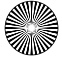
$$\text{Value} = \$10{,}000_1(1+g)/(1+0.2)^1 + \$10{,}000_2(1+g)^2/(1+0.2)^2 + \ldots + \$10{,}000_n(1+g)n/(1+0.2)^n, \text{ and where } g = 10\% \tag{1.3}$$

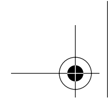
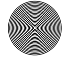
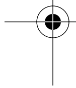
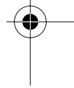
$$\text{Value} = \$10{,}000/(0.2-0.1) = (10)\$10{,}000 = \$100{,}000 \tag{1.4}$$

Again, equation (1.4) is just a simpler way of expressing equation (1.3), which says that the property is now worth $100,000 (10 times earnings) because this income stream is expected to grow at 10% annually. Here again the assumptions underlying the valuation may cause differing views as to the property's value. If it is easy to disagree on the income measure to be used and what the appropriate discount rate is determined to be, then it is really easy to disagree on what the future rate of growth will be.



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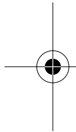
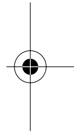
Equation (1.4) is the most commonly used framework to determine value. That is, the value of a commercial real estate property depends on how much income it will generate, the appropriate rate at which that income should be discounted, and how much that future is likely to grow in the future.

Overextended Borrowing

Leverage is a good thing, but too much leverage can be a bad thing. Leverage increases the potential return on a project, while at the same time increasing the risk associated with that project. This is why it is better to optimize leverage than maximize it. Too much borrowing jeopardizes the success of a real estate investment as surely as too little leverage. It is a matter of balance to be decided by the investor's taste and preference for the trade-off between risk and return.

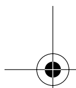
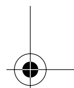
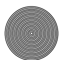
Management Expertise Required

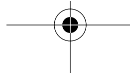
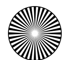



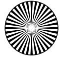
Where ownership of the property is direct, the commercial real estate investor is going to need to be involved with searching for the project, evaluating the project, financing the project, and (if acquired) managing the project. Even where the commercial real estate investment involves a sale–lease-back arrangement and there is no property to search for, and the evaluation is cut and dry, the project will still not manage itself. There are always ongoing issues to be dealt with between the lessor and lessee. Commercial real estate investment is not a passive activity. It requires active, focused, intense participation or things are likely to go terribly wrong. Commercial real estate investment is not for the detached.

SUMMARY

Many investors have an excessive concentration of equities in their investment portfolios. Whether such equities are directly held, the result of employer offered stock options or held indirectly through mutual funds, such investors can achieve significant reductions in risk without loss of potential return through investment in real estate. Indeed, the astute investor can often both increase return and reduce risk through real estate investment. This "magic" is accomplished through diversification and the power of compounding returns. The tried-and-true approach to building wealth over time comes from a portfolio of one-third equities and long-term debt, one-third real estate, and one-third liquid assets. Diversification minimizes risk and wealth grows by compounding earnings. This is a bedrock foundation for wealth building that will withstand



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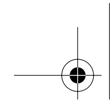
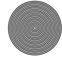
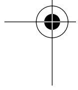
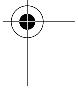
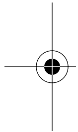
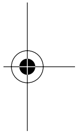





the storms of adversity that are sure to come. Portfolio structures composed of trendy stocks are built on sand and inevitably collapse.

Real estate provides a mosaic of opportunities and risks. No one sector is inherently better than another. Office buildings may be hot in California, but dead in New York. Residential housing can be going great guns in Arizona, but suffering from oversupply in Tennessee. The good news for investors is that the market is so complex and dynamic, there are always good investment opportunities to be found somewhere. Of course, not all real estate investments are appropriate for all investors. Investors will vary by their degree of expertise, their willingness to commit time and energy to an investment, their ability to use the tax advantages inherent in real estate, their need for liquidity, their access to capital, and their taste for risk. Still somewhere within this mosaic, the patient real estate investor will find the opportunity that is right for him or her.

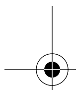
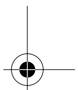
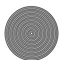
Table 1.1 presents a synopsis of the strengths and weaknesses of the different types of commercial real estate investment. Potential real estate investors should use this chart to find that combination of traits that are most appealing and then go to the relevant chapter to learn more about the area should use this chart.

All strengths and weaknesses are rated on a scale of low to high. It should be noted that these are general rankings. Local market conditions, or unique circumstances characterizing a particular project, could alter this rating in that instance. These rating should only be used as a general guide. More detailed information is contained in the referenced chapters.

Most forms of real estate investing permit or encourage a high degree of financial leverage. Greater financial leverage means an increased ability to fund a project with debt. The ability to use financial leverage in real estate investing is an advantage because financial leverage will give the investor a greater return per unit of equity capital. For example, a single-[family residence is bought for $100,000 with $5,000 equity and a mortgage of $95,000 and the property appreciates 10% to $110,000 in one year. Then the investor’s gain is not 10% but 200%, that is, the $5,000 of equity has now become $15,000 of equity. Of course, financial leverage can also be a disadvantage because it implies an increased interest expense. Interest expenses are fixed and increase break-even points as a result.

Operating leverage occurs when a rise in sales or revenues brings about a more than proportionate increase in profits. Almost all real estate properties have high-operating leverage because the bulk of real estate expenses are fixed. This property of real estate simultaneously makes real estate such an attractive proposition in terms of potential return and increases the risk of failure if those fixed costs cannot be covered by receipts.

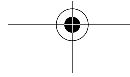
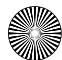
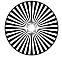
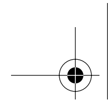
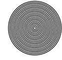



TABLE 1.1 Advantage and Disadvantage Comparisons by Types of Commercial Real Estate

Type of Property	Chapter	Financial Leverage	Operational Leverage	Inflation Resistance	Tax Advantage	Own Business	Compounding Properties	Lack of Liquidity	Valuation Difficulty	Management Expertise
Single-family	6	High	Medium	High	High	High	High	Medium	Medium	Medium
Apartments	7	High	High	High	High	High	High	Medium	Medium	High
Condos	8	High	High	Medium	High	High	Medium	Medium	Medium	Medium
Time shares	9	Medium	Medium	Medium	Low	Medium	Low	High	High	Low
Undeveloped land	10	Medium	High	Medium	Very low	Medium	High	High	High	Low
Self-storage	11	High	High	High	Medium	High	Medium	High	Medium	Medium
Restaurants	12	High	High	Medium	High	High	Medium	High	High	High
Shopping centers	13	Medium	Medium	Medium	Medium	Medium	Medium	High	Medium	High
Athletic facilities	14	Medium	Medium	Medium	High	High	Medium	High	Medium	High
Office buildings	15	High	High	High	High	Medium	High	High	Medium	Medium
Industrial	16	High	Medium	Medium	Medium	Medium	High	High	Low	Low
Parking lots	17	High	High	High	Medium	High	High	High	High	Medium
Hotels & Motels	18	High	Medium	High	High	High	Medium	Medium	Medium	High



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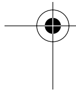
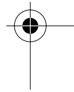
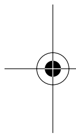
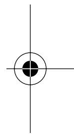



Real estate properties are capable of functioning as an inflation hedge. That is, when prices in general go up, the rents or fees derived from owning real estate will also rise. This attribute of real estate combines with the use of leverage in real estate. Where the debt carries a fixed interest rate, the effect of inflation is to lower the value of the debt repayments. Under this scenario, creditors lose and debtors win.

Real estate property may generate tax savings that augment the real value of the property. In general, tax advantages arise from the use of depreciation and the fact that interest expense is tax deductible. Many real estate investments are not profitable until the tax advantages are considered.

Investing in real estate is not necessarily a passive business. Even if there are no operational demands on the investor, managing a portfolio of properties requires many administrative tasks that can amount to a full-time job. In addition, the investors may also elect to take on certain operational responsibilities with respect to the property owned. An office building owner may wish to take charge of the maintenance function, for example, or a shopping center owner may wish to find tenants on his or her own. Some investors may well consider the opportunity to support themselves by running their portfolio as their own business as a good thing. The framework used above treats the ownership attributes of a type of property as a good thing.

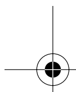
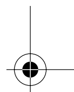
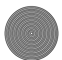



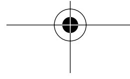
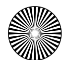
One of the most important components of the wealth building process is the ability to compound earnings. As a general rule, real estate properties are very good for facilitating this process because of the opportunities naturally provided to reinvest in a property already owned or a similar property.

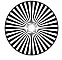
In all real estate markets, there are times of excess demand. Converting the value of a property into cash by selling it is not a problem. Sadly, all real estate sectors sooner or later experience conditions of excess supply. Under these conditions, it can be very hard to access the value of a property through a cash sale. Frequently, the property becomes impossible to sell without significant reductions in price, or without some form of seller financing. Lack of liquidity constitutes a serious risk to all real estate investors.

Because real estate properties tend to be unique as a result of location or the characteristics of the improvements located on that property, determining the value of that property may be difficult. Of course, "comps"—comparisons—can always be found, but frequently those comps are not really comparable for one reason or another. Valuation difficulty can create a liquidity problem.

Management expertise is often required with any type of real estate investment. The owner-investor must always make a host of decisions



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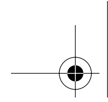
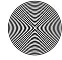
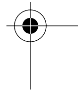
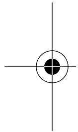
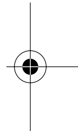




TABLE 1.2 **Suitability Index for Investors by Type of Investment**

Type of Property	Chapter	Suitability for an Investor Based on Experience
Single-family	Chapter 6	Little experience
Apartments	Chapter 7	Some experience
Condos	Chapter 8	Little experience
Time shares	Chapter 9	Little experience
Undeveloped land	Chapter 10	Little experience
Self-storage	Chapter 11	Little experience
Restaurants	Chapter 12	Some experience
Shopping centers	Chapter 13	Lots of experience
Athletic facilities	Chapter 14	Some experience
Office buildings	Chapter 15	Lots of experience
Industrial	Chapter 16	Lots of experience
Parking lots	Chapter 17	Some experience
Hotels & Motels	Chapter 18	Lots of experience

from determining the value of a property to financing the property and to taking care of an array of details associated with ownership (e.g., liability insurance.) Of course, this expertise will be less for some types of properties and more for others.

The manner in which these advantages and disadvantages impact the different property types are discussed in the referenced chapters. However, these advantages and disadvantages may be summed up in the "Suitability Index" shown in Table 1.2.

Success in real estate investing is a function of the experience (knowledge and expertise) of the investor. The first-time investor should not go for an industrial or office building property unless very special circumstances are present. Success in this area comes best to the novice who starts small and simple and acquires the necessary experience for success over time.