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Commercial Real Estate Investing

It's Not Only for Billionaires

Do you have the mind-set of a winner?

Here's how a billionaire-wannabe thinks: "Someday, if I'm as wealthy as Donald Trump, I'd love to own a bunch of properties in my town."

Here's how a future billionaire thinks: "The way to become as wealthy as Donald Trump is to start owning commercial property in my town."

Commercial property isn't your destination; it's the way you will reach it.

Commercial Real Estate Is the Invisible Giant

You can't pick up a newspaper these days without seeing some story—usually negative—about the residential real estate market. But there's another, quiet, vast real estate market that is quite independent of the ups and downs of residential property.

Just what is commercial real estate? It's

- Office buildings (all the way from skyscrapers down to a small building with a dental office in it)
- Apartment buildings with five or more units
- Stores, whether they're in big malls or small, local shopping centers
- Hotels and restaurants
- Industrial space (factories, warehouses, and so on)

It's no wonder that the value of U.S. commercial real estate is many trillions of dollars, given that we spend most of our waking hours working in it, shopping in it, and even celebrating and vacationing in it.

I'm not going to keep you in suspense. Here's a huge secret, right on the first pages of this book:

> The wealth opportunity with commercial real estate is enormous for the very reason that most people think they could never own it.

If investors only understood how it's possible to make a fortune from commercial real estate, they would ruin the market for the rest of us. So thank your lucky stars that commercial real estate remains shrouded in myth and misinformation for millions of real estate investors.

They convince themselves that it's not worth doing commercial real estate because they imagine a series of huge barriers in their way. Here are just three of the many psychological barriers to entry:

- "The bigger the building, the bigger the down payment that I need."
- "I couldn't possibly own a shopping center; I know nothing about retail sales."
- "All the good deals must have long since been picked over: I'll see only the lousy ones."

I recognize that even you might be spooked by some of these psychological barriers. That's okay: We cover each of them in this book. By the time you're finished reading, you'll have a clear plan for how to go from where you are right now to owning that first commercial property.

Right away, I can tell that *you* are different. After all, you're not frozen in your tracks, unwilling to consider commercial real estate. In fact, you've taken the crucial step of buying and actually reading this book. You may find this hard to believe, but you've just put yourself ahead of 80 percent of those billionaire-wannabes.

There are wonderful, perceived *force fields* around commercial real estate that keep most investors out. Let's look at some of the excellent benefits you'll enjoy once you're part of this informal but highly successful club.

Six Reasons to Invest in Commercial Real Estate

It's Not about Your Wealth or Lack of It—It's about the Property

I got started in real estate with less than $800 to my name. I now own a very large portfolio of commercial real estate. It's not as big as Donald Trump's, but I'm getting there!

You may be in a situation that is similar to mine at the beginning: no money, no knowledge of real estate, no connections, and working a full-time job.

What was my big break? I recognized two life-changing principles early on, and I'm now handing them to you:

Principle #1: The better the deal, the less people focus on me and the more they focus on getting that deal. If I had a clear winner on my hands, they really could not care less that I was an inexperienced investor. They just wanted the deal.

Principle #2: Real estate is an inefficient market. That means bad, good, and great deals are being generated all the time, and they pop up in unexpected places.

If you want to buy stock in Starbucks, you'll get the same price whether you're in Peoria or Pakistan. But there is no such central clearinghouse for real estate deals. On any given day, hundreds of business situations change in your town: Companies merge, expand, and decide to relocate. Contracts are awarded, marketing campaigns take off, and products get publicity. Other companies change hands because the owner dies or retires. These events often result in a property being put up for sale. There is no single way that happens. Instead, the property may be listed by a broker, or an ad may appear in the paper. The owner may be thinking about whether to sell when he meets someone at a party and they strike up a conversation.

Sometimes the owner is out of state or even out of the country and does not know any local buyers or brokers. Unlike that Starbucks stock, this hodge-podge of a real estate market makes for great opportunities that were hidden yesterday, and lie uncovered today.

After you read and follow my system for attracting deals, two things will happen: You'll see a lot of worthless deals; and every so often you'll come across a real gem.

That's why you can start from where you are right now, and make a fortune in commercial real estate. Your marketing systems will eventually find a gem that's so good, no one will care that it's your first deal.

Commercial Real Estate Will Open Up a Huge Segment of Your Local Market That You Previously Avoided

Confining yourself to investing only in single-family homes is like looking at your town through a drinking straw. The whole town is there, but your view is incredibly narrow.

Once you are comfortable with my systems for investing in commercial property, you'll be throwing that straw away. Everywhere you look, you will see opportunities that never occurred to you before. You will have become a *transaction engineer*.

- Maybe there is a parcel of land next to a highway where you can now envision a small office building or strip mall. You could buy the land and flip it to a developer for a nice profit.
- Maybe there is a run-down *strip mall* (several stores next to each other in a row) that you pass every day while driving to work. You notice that with some simple improvements this area could be getting much more business.
- You see a *For Sale* sign on a small office building, and contact the owner. You realize that the numbers work for you to buy and hold that property for long-term cash flow and appreciation.

Let your competitors wrestle each other over the single-family home market. Commercial real estate will vastly broaden your horizons.

Don't get me wrong: I'm not suggesting that you must become expert at every type of property. I just want to open your eyes to the possibilities—right in your own backyard—that you may not have ever considered.

You have to start somewhere, so it's fine to pick one type of property and get good at it. But don't stop there. The more property types you can invest in, the easier it will be to find a great opportunity.

Start anywhere you like—but make sure that you *start*. You *do* want to be a transaction engineer, but you do not want to have analysis paralysis, where you never quite get around to making offers and doing deals.

Later we'll talk about how to take the weight off your shoulders and how to build a low-cost team of professionals to do the heavy lifting.

Less Competition: They're Scared Off Because They Don't Know the Secrets You'll Discover in This Book

In my investing and speaking travels around the United States, I talk with a great many people. One of the most common excuses I hear for not getting involved in real estate is: "I'd love to, Dave, but you don't understand how severe the competition is in my area."

I have two responses to that: First, if you have the right marketing systems in place, you'll be successful regardless of how much competition there is. Second, that's all the more reason to branch out from single-family homes into commercial property, where there are fewer investors.

Notice that I said *branch out* and not *do instead*. I still invest in single-family houses when a great deal comes along. It's like finding money on the street, only this kind of money is 10 or 20 thousand bucks!

There's no need to *stop* investing in one type of property, once you know how to invest that way. Instead, you simply focus on one type while keeping your eyes open to all the other possibilities that come your way.

Later in this book, we'll systematically explore each of the myths surrounding commercial properties, and how you can confidently move forward where other people fear to tread.

Cash Flow

Cash flow is king. It will set you free.

Early in my investing career, I thought I had it made. I had gone from being a dirt-poor landscaper (ha-ha) to a multimillionaire in just under four years. There was only one small problem:

I couldn't pay my bills.

How could that be? It was because my millions were on paper. I truly did have that wealth, but it was tied to the eventual sale or refinancing of my properties. I was not receiving a regular monthly check.

That's when the next part of my education occurred. I realized that the true lubricant of business was steady cash flow. It didn't matter how powerful my real estate engine was; without that cash flow, the gears would grind to a halt.

Commercial property provides this business lubricant—cash flow—in superior amounts. Certainly, you can become wealthy by investing in single-family homes. But you better be doing a string of them in quick succession in order to provide the cash flow you need from month to month. That sounds like a lot of work to me.

With even a single commercial property, you can look forward to a nice check being dropped into your mailbox every month like clockwork.

At first the checks may be smaller, because your number-one priority is to cover the cash flow needs of the property. You'll have operating expenses that must be paid each month, and *capital expenses* (major repairs) that will come up from time to time.

If you use a tested-and-proven system to buy right, you'll have a cushion of cash flow that more than covers the property needs. You get to pocket the rest of that money.

Your first goal may be to accumulate enough positive cash flow so that it equals what you are earning in your full-time job. Then you'll have the option to quit that job and become a full-time investor.

After that goal is fulfilled, no doubt you'll have other ones: Perhaps you'll use the additional cash flow to purchase more properties. Maybe you'll use it to help a struggling loved one, send your kids to college, go on a long vacation, or all of the above.

Cash flow will indeed set you free. It will give you the confidence and the ability to do the things in life that you couldn't do before.

You Can Think Big But Still Start Very Small

You've heard Donald Trump say it: "If you're going to think, you might as well think big."

Commercial property has two very important characteristics: It allows you to get as big as your imagination will let you, but it also allows you to start as small as you like.

Dreams without action are not impressive. Commercial property is the path from your dreams and modest initial actions all the way up to your ultimate financial goals.

I remember sitting at a restaurant in Boston with a friend, James Romeo. At the time I owned several small multi-family buildings. He knew that I had been spending a lot of time in my investment business and that I had accumulated a nice little portfolio.

James asked if I would be available to go to a social event he had planned. I told him I had to look at some new properties. He sighed and said, "Dave, when will enough be enough?" I looked out the window and said, "When I buy *that*." I was pointing at the Prudential Tower skyscraper.

He rolled his eyes, because he knew the biggest thing I owned was a six-family building. But I was already thinking big back then. I later made sure to send James a magazine that featured my story and described my portfolio, which did not include the Prudential Tower, but had increased 20 times since we met for lunch that day.

Start as small as you like, but again the most important thing is to *start*. Once you see the system working for you and that monthly cash flow check being delivered, you'll soon be thinking ever bigger. You will realize that economies of scale favor larger properties and it's actually *easier* to own larger properties, because they can support a larger team to run them for you.

When You Follow Proven Systems, Commercial Properties Offer Lower Risk

I know: How can something bigger than a house have less risk than a house? It seems odd, but it's true.

Let's say you're renting out a single-family residence. If you lose your tenant, you've lost 100 percent of your income. If you can't find another tenant, pronto, you'll be covering the next mortgage payment from your own pocket.

In a commercial property, you'll have several tenants, and even hundreds. You still may lose one, but the others will continue to pay rent. This cash flow should cover most, if not all, of your mortgage payment. Each tenant is like a pillar supporting your investment. If you ask me, it's better to have lots of pillars, rather than just one.

How You Can Make Money from Commercial Investing

With some investments you simply try to buy low and sell high. Commercial real estate gives you a whole rainbow of opportunities to profit. Let's briefly look at some of them.

Equity Build-Up

This is where the real money is. Equity build-up happens in two ways.

The first is through paying down the mortgage principal. You'll have your tenants to thank for that, whether it's a multi-family, office, retail space, or another type of property.

Each month they will give you a big slice of their income in the form of rent checks. You use a portion of that money to make the mortgage payment. In one sense, your tenants go to work each morning to buy the building *for* you. What a country!

I remember when I first heard of this concept. I was watching a television documentary on the life of Harry Helmsley. When asked why he began investing in commercial properties, Harry said, "I always liked the idea that a group of people would pool their money together to pay off the mortgage on my building. I also liked the idea that they would give me extra money at the end of the month that I could use to reinvest, put into a savings account, or just have some fun with."

That was enough inspiration for me!

The second way to get equity build-up is through appreciation. Over time, real estate values in most areas go up. Yes, appreciation is subject to cycles, but over the long term, the line on the graph trends upward. Some markets appreciate faster than others. The markets on the East and West coasts tend to appreciate higher and faster than markets in the Midwest.

Cash flow may be the vital lubricant of your real estate machine, but appreciation is the giant engine. Cash flow allows you to run your properties, quit your job, and start enjoying the finer things in life. Appreciation comes more slowly, but has the potential to add many zeros to your bank account.

Emerging Markets

Real estate investing is my focus, but the study of emerging markets is my passion. At any given time—regardless of what the national economy is doing—there are markets around the United States that are just on the verge of explosive growth.

They are about to appreciate much faster than other markets around the country, and they can make you a great deal of money in a short period. My book, *Emerging Real Estate Markets*, describes in much more detail how to find and profit from these markets.

The key concept to understand is that *all real estate markets are local*. It doesn't matter what the national headlines are screaming. A factory shuts down in one town, and somewhere else an oil company has just opened a new branch office. A Michigan automaker announces more layoffs, but a foreign automaker announces plans to build a factory in Kentucky.

There are two tricks to making money in emerging markets: First, you must be able to locate these markets slightly before most other investors know that they are good. Second, you must be willing to invest when other people think you're crazy.

That's because you will be *buying low*, or investing when other people don't see the value. That positions you to *sell high*—in other words, when other people think you're crazy for selling too soon.

Just get used to the feeling of people thinking you're crazy. It's not hard to do, because soon you'll be much wealthier than they are!

There are emerging markets for commercial properties all around the United States at any given time. The best part is, different types of commercial property follow different paths in the market cycle. Simply because a market is emerging for apartments does not mean that it is emerging for retail space.

As a matter of fact, retail space generally lags behind apartments: First come the announcements that new job opportunities will be opening up in an area. That creates a demand for office space.

Then the people who will work in those offices begin to move into town. Because homes can't be built fast enough, the apartment market suddenly heats up.

Many people want to see if their job will work out, and they want to get a good feel for the community. They check things out by renting first. After their leases expire, they start to buy single-family houses. Retail space tends to follow housing surges, as merchants realize they can make money by moving closer to where people live and work.

Discovering how to recognize the signs of emerging markets—and then acting on that knowledge—will make you a very rich person.

Forced Appreciation

This is one of the fastest ways to make money with commercial properties. The concept is also called a *value play*. Whenever you look at a deal, always look for ways to force appreciation beyond what the local market may naturally generate.

To force appreciation, you must find a deal with a slight problem. It won't be a problem for *you*, but it's been a nagging issue for the previous owner. Maybe he's been afraid to raise rents, so his rents are under market. Maybe he is charging the correct amount for rent, but has higher-than-normal vacancies. Perhaps his expenses are running high.

These are all opportunities to buy a property with a built-in reward, as long as you buy based on the *actual numbers*. That is the key to buying right with commercial properties.

Let me take a minute to talk about the numbers that a potential seller will propose to you. Most sellers try to sell based on projected or *pro forma* numbers. This means that they are basing their price on what they *think* you can earn after you buy the property. The problem with *pro forma* numbers is they are not real. You are buying based on future cash flows that may never materialize.

That is a speculator's game, and way too risky for my blood. If you want to gamble, go to Vegas. If you want to make solid investments, base them on actual results.

Back to forced appreciation: All you have to do is raise rents up to market levels. You'll first have to wait until leases expire, because leases transfer with ownership. Apartments usually have one-year leases. Office buildings and other commercial properties have 3-year to 20-year leases.

Here's why raising rents also raises your property value: Commercial properties are primarily valued on multiples of their cash flow. (There are two other valuation methods that I discuss later in the book, but cash flow is the main one.) This means that for each notch that you raise your *net operating income*, you've just raised the value of your property by multiple notches.

One of my favorite value plays is to find a property with higher-than-normal expenses. Most properties operate with expenses of about 50 percent of gross income. When you see the actual financials of a property with higher expenses, determine if you can lower those expenses to the average level. (Later I show you how.) If you can, you may have a winner on your hands. Without doing any significant work to the property, you can improve net operating income and truly improve the property value.

Repositioning

This is a special type of value play, and one of my favorites. When you *reposition* a property, you change the tenant base or significantly alter the appearance of the property. Sometimes you do both.

You may find a property that needs some tender loving care. We call this *deferred maintenance*. Maybe it's an okay property, but it hasn't been upgraded in over a decade. It may look tired and out-of-date. There may also be the wrong type of tenant leasing the space.

Back when I was broke, I would visit a suburban strip mall in Hingham, Massachusetts. Its *anchor tenant* (that is, its biggest store) was a discount department chain. Another store was even *more* discount: It specialized in dinged-up furniture and flawed clothing. The mall included other typical shops, such as a pizza joint and a Laundromat. For years the mall had languished as a working-class shopping center.

In the meantime, the demographics in Hingham had changed. The city could now support higher-end enterprise. The working-class mall gained a new life and was repositioned as the nation's first *lifestyle center*. In place of the blue-collar stores, high-end shops like Williams Sonoma, Whole Foods, and Panera Bread moved into the refurbished spaces. The place took off, and is now one of the most popular shopping centers in the area.

Apartments are sometimes great candidates for repositioning. Let's say that you find a tired apartment building in a good area. This property has not been kept up well, so it's attracting tenants who are even less well-kept.

To reposition the building, you first spruce up the exterior, focusing on the siding, roofing, and parking lot. You upgrade the landscaping, put new signage on the property, and create a nice leasing office. You then work on certain strategic improvements inside the property.

With the property now looking much better, it's time to reposition those tenants. You get rid of the tenants who pay slowly, never pay at all, or are criminally inclined. Replace them with the tenant profile that you are targeting.

This is a process that can take several months, absorbing more time and money than the simple value-play of raising rents. The rewards can be quite spectacular, though. Not only can you fill your vacant units, but soon all of the units are paying substantially more in rent. Because your property value is calculated at a multiple of the net operating income, you've just skyrocketed the worth of the property.

When you come across a property that fits the profile I just described, you should definitely consider it for repositioning. I wrote an entire book on the topic called *Multi-Family Millions*, published by John Wiley & Sons. This concept of making low-cost, high-payoff changes to both a property and its tenants is enormously powerful.

Tax Deferral Through 1031 Exchanges

The Declaration of Independence may tell us that *all men are created equal*, but the government definitely favors us real estate investors!

Not only do we get to depreciate (that is, take a tax deduction on) the value of our investment real estate, but we also get to use an astonishingly powerful tool called a *Section 1031 Tax-Deferred Exchange*.

It's like an IRA account on baseball steroids. You can legally sell one property and buy another, while deferring all tax payments on your profits. That doesn't sound impressive until you stop to think about it.

Let me give you an example. Say you bought an office building for $1 million and you sold it two years later for $1.5 million. To make this very simple, I will assume that there are no closing costs in the transaction. This means that you will walk away with a $500,000 profit.

You can't walk far, though, because your friendly IRS agent is standing there, wanting 15 percent of your profit to cover your long-term capital gains tax. So you hand him $75,000 of your profit, leaving you with $425,000 to reinvest.

If you put 20 percent down on your next property, you could afford to purchase one for $2,125,000, again assuming no closing costs. Not bad.

With the 1031 Tax-Deferred Exchange, however, you can tell the friendly IRS agent that all of your profit is going right into your next property. (There are detailed rules on how to do this, but just bear with me while I describe the general principles.) The IRS man nods, steps aside, and tells you to have a nice day.

Because you can use all of your profits for a down payment on the next deal, you can buy a property worth $2,500,000 ($500,000 is 20 percent down on $2,500,000). You've just bought a property that's $375,000 larger, with that much more potential for cash flow and appreciation.

You can do this as many times as you wish, and each instance will be tax-deferred. Yes, eventually you will pay taxes on that profit. But it's now much greater profit, because 100 percent of your proceeds have been working for you, instead of losing a portion of the profit going to tax payments after each transaction.

The second-best part is that the process is entirely aboveboard. No tax loopholes are involved. And what's the *very* best part? You've made much more money!

Imagine exchanging the same properties over and over again. After not many transactions, you could easily be buying properties worth millions, tens of millions, or even more.

In the Next Chapter

This chapter has been merely an appetizer. I wanted to give you a taste of what an excellent decision you made by picking up this book. Commercial real estate is a gem that we all see every day, and is psychologically off-limits to most investors—but not to you.

It's time to buckle up, because in the next chapter I show you how to find your very first commercial cash cow that you can milk for a good long time.