

HIRC

The High-Risers Club

11.5.2024 – Commercial Transacting Part 2

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Welcome

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Commercial Building Sales and Valuation

**What is important to the tenant /
buyer / seller / landlord**

Commercial Building Sales and Valuation

Lease return vs rate

Commercial Building Sales and Valuation

1. **Selling a commercial building as is. Is there anything I should be aware of?**
 - a. **Due Diligence:** Conduct thorough inspections and due diligence to understand the condition of the property.
 - b. **Hidden Costs:** Be aware of potential hidden costs associated with the property's current condition. Factor in possible renovation or repair costs into your budget.
 - c. **Future Potential:** Despite buying the property as is, assess the potential for future value appreciation or rental income. Evaluate if the property aligns with your long-term investment goals.

Commercial Building Sales and Valuation

2. Commercial listing description indicates Class A Building. How do I know if it's a Class A building, and what does that really mean? (cont.)

Class A building key features:

- Best in market
- Good location and access
- Professionally managed
- Excellent tenants
- First-rate amenities
- Newer building
- Higher market rent
- Least risk for an investor

Commercial Building Sales and Valuation

3. I have an appointment with a potential seller. Wants to list his business (gas station) it is on a 30 year land lease with 28 remaining. Says he doesn't show much income on his tax return. How do we value this?

Selling businesses is a specialized field, often handled by business brokers. Personally, I avoid selling businesses because it requires expertise that few realtors, including myself, possess. Businesses for sale are commonly listed on dedicated platforms like BizBuySell, rather than traditional real estate listing services.

Business valuation typically mirrors the approach used for investment properties, primarily based on the net income (income - expenses), with a multiple applied. The specific multiple can vary significantly depending on factors such as the type of business, its financial stability, lease duration, and market competition. I hope this information proves helpful.

Commercial Building Sales and Valuation

- 4. Working on a property valuation for a building that is about 28,000 square feet has one occupant and is classified as office/warehouse. Since there is no rent, should the Sales Comparison Method be used vs the Income Method to determine value?**

The way I approach valuing properties with no income is as follows:

1. Sales Comparison Approach:

- a. Similar to residential properties, I gather information on recently sold properties that are similar in size, location, and characteristics to the subject property. Specifically, I focus on industrial properties, particularly those with office/warehouse space.
- b. I make adjustments for any differences in size, condition, age, location, amenities, and other relevant factors. This analysis helps account for variations between the comparables and the subject property.
- c. Based on the adjusted sales data, I determine a range of values for the subject property. This range helps establish an estimated market value.

Commercial Building Sales and Valuation

4. Working on a property valuation for a building that is about 28,000 square feet has one occupant and is classified as office/warehouse. Since there is no rent, should the Sales Comparison Method be used vs the Income Method to determine value? (cont.)

2. I analyze the market as if the property were rented at market value and estimate its value using the Direct Capitalization Method ($I/R = V$). This allows me to gauge its potential value if it were generating income.
3. I also consider the value used by the municipality for reference and to gain further insights into the market.
4. Additionally, I may reach out to an appraiser for their opinion, as they can provide additional guidance and expertise.

There is no perfect approach, but I prefer to explore different valuation methods and learn from the data. Ultimately, the market will determine what someone is willing to pay for a property.

Commercial Building Sales and Valuation

5. Are commercial loans assumable?

In most cases, commercial loans are not assumable. There are some lenders however, that will permit, for example an Agency Lender (Freddie Mac or Fannie Mae). Requires review of the loan docs.

Commercial Leasing and Commissions

1. How do we have the conversation with property owners about how commercial lease commissions work?

Commercial Leasing and Commissions

2. Where do landlords get the \$ from to pay a commission—say a 5-year lease term @ a 5% commission?

Commercial Leasing and Commissions

3. I asked about rent increases and the landlord's response was 3%. Does that mean annually?

- It would typically mean the base rent increases 3% annually ... if the rent was \$20NNN yr 1, then yr2 would be $\$20 \times 1.03$ or \$20.60NNN
- There are step by step examples in the "Commercial Real Estate for Residential Realtor Course" on pages 52-55

I also asked if tenant reps are compensated/how much, and he said yes, 2.5%. How does that work with a minimum of 3+ years lease required?

As an example:

If the Rentable sf is 2500sf and the rent is \$20NNN and the lease length is (3) years and the commission is 2.5 % of the 3 year lease rent total :

$2500 \text{ sf} \times \$20/\text{sf} \times 2.5 \% \times 3 \text{ years} = \3750 commission

Commercial Leasing and Commissions

4. What would be the industry standard for an agent to expect from a listing agent as compensation when bringing a tenant into a commercial space?

The industry standard for compensation for an agent who brings a tenant into a commercial real estate space is typically a commission based on a percentage of the lease value. Specific rates can vary based on local market practices and negotiations, but a common range is 2.5 to 3%. However, when dealing with a national commercial broker and a high-quality tenant, such as a national or financially strong tenant willing to sign a longer lease (5 to 20 years), they may request a higher commission, often 5% or something similar. It is essential to establish and agree upon the compensation arrangement between the listing agent and the agent representing the tenant before initiating any leasing activities.

Tenant/Vetting Process

- 1. Will the LOI be considered the application for a lease? In this case, I am representing both the landlord and the potential tenant.**

In the commercial real estate industry, the Letter of Intent (LOI) is commonly used to outline the key business terms of a deal. These terms typically include the lease rate, lease term, allocation of taxes, insurance, common area charges, utilities, fit-up allowances, signage options, and more. Once both parties agree to these terms, they can proceed to drafting and signing a formal lease agreement.

Unlike residential properties, commercial landlords usually don't require applicants to fill out an application form. Instead, they may request financial documents, such as financial statements or tax returns, and may also require a security deposit equivalent to two months' rent, references, and a lease guarantee. The specific requirements can vary from landlord to landlord.

Tenant/Vetting Process

2. When we see Loopnet listings that don't have all the detail, what's our best course of action?

If you are working with an experienced Listing Agent and/or a full-time commercial agent, they may request you and your client to sign a Non-Disclosure Agreement (NDA) or register your name and contact information. Once completed, they will provide you with the information they have, which is typically quite accurate. Yes, you would make an offer that is subject to receiving accurate and reliable numbers.

The LOI would have a due diligence clause which includes: financial, physical and legal due diligence. The financial component is where you would request various documents such as a current Profit and Loss statement, two years' worth of tax returns, a current rent roll, and copies of the leases. It's important to note that the due diligence phase begins after the contract is fully executed, and you receive the specific due diligence documents outlined in the contract. For detailed guidance on the documents to request from the listing agent, prior to submitting an LOI, please refer to Step 8, page 76 of the buyer case study in the Commercial Real Estate for Residential Realtors course book.

Cap Rate, Financing, and Cash Flow

1. A client asked me how much apartments buildings were selling per door. What does that mean, and how do I know?

Cap Rate, Financing, and Cash Flow

2. If a client is in making an offer on a property at 5.5 cap and is getting financing at 7.23, does this mean they will have negative cash at the start of their deal?

In this situation, a buyer/borrower will have a higher down payment to make the cash flow work in order to achieve Lender required DSCR of at least 1.25.

Cap Rate, Financing, and Cash Flow

3. Is it possible for something to have an "attractive" cap rate of say 8% but not cash flow? I'm showing a 3112 SF office property to a client who would use it for his therapy practice. He'd finance 20% of \$445,000 at 9%. At that rate, rental income would be about \$3,000 less than his debt service.

If the cap rate (8%) is lower than the interest rate (9%), it will lead to negative cash flow. However, you are correct in pointing out that investors and users often approach deals from different perspectives. Users, in many cases, are more inclined to make a purchase based on their specific needs. They prioritize factors such as having control over the space, making the desired capital investments, and avoiding concerns about lease expirations and potential difficulties in lease renewal negotiations. They also enjoy the benefits that investors take into account, such as future value, equity growth, and tax advantages associated with ownership.

Cap Rate, Financing, and Cash Flow

4. If there is no in-place income on, say, a multifamily, do we guess based on market rents, and for taxes, do we use what's on public records even if the property is vacant?

Assuming the vacant multi-family property is not being demolished or repurposed, I have the following insights to offer:

1. Financing a vacant multi-family property presents challenges due to the lack of rental income to consider.
2. If you are selling a vacant multi-family property and the buyer intends to pay in cash, you can follow these steps to estimate the market value:
 - a. Determine market rents to estimate potential income.
 - b. Estimate expenses at around 35-40% of the potential income.
 - c. Refer to the current property tax amount to factor in taxes.
 - d. Apply a market cap rate to estimate the property value.
 - e. Validate the estimated value by comparing the sale prices of similar multi-family properties.

Property Management and Development

- 1. I have a potential opportunity to list a commercial property to lease (not sell); the property needs work, and the owner would like to convert the property to low-income housing. What are the initial steps to engage my client in finding out if his desire for the property is feasible?**

I would conduct thorough research on the planning and zoning regulations regarding land use to determine if the proposed activity is permitted. Additionally, I would reach out to the relevant governing authority responsible for zoning and land use in the specific location of the property to confirm the allowances. In case the activity is permitted, I would inquire about any official checklist or guidelines that need to be followed to ensure that your client completes all necessary steps correctly.

Property Management and Development

2. Will lenders consider market rate rents for vacant units?

Lender can consider market rent for vacant unit if there is proposed lease signed by tenant to become effective once the new buyer purchases the property. Otherwise, cash flow is determined based on 'current in place rent' today; this is what is utilized to underwrite a commercial loan.

Property Management and Development

3. Is there a list of questions that I should ask the agent for an off-market listing? (e.g., industrial/Office building with loading docks)

- You want a rent roll that clearly identifies each unit, indicating whether it is vacant or leased. For leased units, you need information such as the square footage, current rent, expiration date, rent increases, renewal options, and other relevant details. In the course book "Commercial Real Estate for Residential Realtors" on page 76, you can find an example of a rent roll.
- You need a P & L statement to calculate net income (pg 77 from the course book)
- What is the sales price
- In the course book on pg 234, there is the following list of questions I recommend asking the tenant or potential purchaser of industrial space so you can identify their needs. Based on what they need, you can then ask the listing agent if the building has what your buyer needs:

Property Management and Development

3. Is there a list of questions that I should ask the agent for an off-market listing? (e.g., industrial/Office building with loading docks) (cont.)

Questions for a Potential Industrial Tenant

1. Do you need office space? If so, how much?
2. Do you need docks? If so, how many?
3. Do you need overhead doors? If so, how many?
4. How much outdoor parking, and what turning radius for that parking, will be required?
5. Do you need any special floor loads? If so, what are the minimum requirements?
6. Do you need any special ceiling heights? If so, what are the minimum requirements?
7. Do you need any large, clear spans? If so, what dimensions?
8. Do you need any cube space? If so, how much?
9. Do you have any specific electric requirements?
10. Do you have any specific plumbing requirements?
11. Do you have any specific HVAC requirements?
12. Do you have any specific elevator requirements?
13. Do you have any location requirements – highway, railroad, airport, shipping, etc.?
14. Do you have any special equipment requirements?

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Next Session

The Buyer Sequence in a Commercial Real Estate Transaction

**Tuesday, November 12th, 2024
@ Noon Eastern**

Greatness is Within



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