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The Riddle Report

Condos – Developments And Conversions

Most anything that can be subdivided to be sold or rented can be developed or converted to condominiums. When we say "condo" maybe the apartment might come to mind first. Then, you may think of the commercial office building that was converted to condominium offices. Less common are the other, unusual types of condo developments such as condo parking garages, boat marinas, and other properties that are usually rented. Here are examples:

Motel Vacation Units

When Americans go on vacation to resort areas, they often stay in motels that may be located close to the action - the beach, the lake, or the ski slopes. Now, in some parts of the country, motel units are being converted to condo vacation units.

One large motel was converted to 64 condominium units. Kitchen units were added to each unit. The motel had both tennis courts and swimming pools. The condo owners and renters have access to these areas when they are using the units. An outside kitchen with BBQs was added for outdoor cooking and eating. Outside fire pits were also added for toasting toes and marshmallows.

Aircraft Hangars

In a community in the mid-west, an airport residential condominium community was built adjacent to the airport. There are approximately 135 homes built on one-acre or larger lots. Each house has an attached hangar in which the homeowner parks his or her own airplane. The homeowners are able to taxi the aircraft to the 3,400-foot runway owned by the local community. They are governed by a homeowner's association offering full maintenance, fuel and repair services. At some airports across the country airplane hangers have been changed from rentals to condos and individually owned.

Boat Marinas

All along the Pacific coastal waters are condominium marinas. Each boat slip is owned by an individual and the owner pays a monthly fee for the security and maintenance of the boat dock. Governed by a homeowners association much like residential condos. Some marina condominiums are just a boat dock and others are very complex. On the Chesapeake Bay in Maryland there is a condo marina with 168 slips varying in size from 30-50 feet with amenities including on-site marine service, heated bathrooms with dressing rooms, showers, an outdoor grill area, a fish cleaning station, storage areas, and a lounge for entertaining

Just about any kind of development or building that can be rented can be converted to a condominium. ❑

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In This Issue

Real Estate Options

An option on real estate is an extremely versatile investment tool that comes in a variety of forms that can be used for a variety of purposes. The primary use of the option is that it gives the optionee (the party holding the option) control over property (in the sense of the right to buy it) for very little cash. It gives the most leverage and conserves cash, both very desirable for investors. An option gives the holder the right to buy a specific parcel of real estate at a specified price, on specified terms within a specified period.

An option can be compared to (1) a contract of sale with a liquidated damage clause, (2) a sale with a nonrecourse purchase money mortgage, and (3) a lease containing an option to purchase.

Contract of Sale

Instead of an option, an investor could enter into a formal contract of sale containing a liquidated damage clause. This is a contract that the investor may walk away from, subject only to the loss of the down payment as liquidated damages to the seller. The advantage of an option is that it is less complicated (and so may involve less negotiation and legal fees) than a contract of sale although it is undoubtedly a better idea to attach a contract of sale to the option agreement so negotiating problems do not arise later if the option is exercised. On the other hand, a seller may not be willing to give an option, preferring a contract under which the seller retains the choice of either accepting the down payment as liquidated damages or seeking actual damages in a larger amount from the buyer.

The prospective buyer does suffer some limitation of rights as an optionee because the holder of an option lacks a legal or equitable interest in the property (whereas a contract vendee has rights as set forth in the contract).

An Alternative

As an alternative to taking an option on property, an investor may purchase the land, acquiring legal title from the seller who takes back a standing (no amortization) purchase money mortgage equal to 100 percent of the sales price, with interest to be paid annually. The mortgage is nonrecourse (the buyer having no personal liability), so the seller's sole remedy in the event of a default in payment of the interest is to repossess the land. If the purchase is of undeveloped land and the mortgage contains a provision for the release of individual parcels, the mortgage functions in the same manner as a rolling option.

Amounts received by the seller as interest each year are taxed as ordinary income, while the purchaser may be entitled to a deduction for interest paid, subject to the tax rules regarding deductibility of interest. By comparison, annual payments under a long-term option would not be income to the seller if properly structured and would not be deductible by the buyer.

Lease With Option to Purchase

Another alternative to the use of a straight option is a lease containing an option to purchase. In this arrangement, the investor can obtain immediate possession of the property as a tenant, paying rent rather than an option fee. This approach makes sense for income-producing property. The investor is in a position to earn a return over and above the rent paid to the landlord while at the same time retaining the right to acquire ownership of the property at a future date. Rent income is taxable to the landlord as received, and is deductible by the tenant assuming other requirements for rent deductions are met. ❑

Percentage Lease And The Seasonal Business

The choice of the type of lease for commercial space leased by a retail business is usually a percentage lease, meaning that the rental amount is determined as a percentage of the gross receipts of the business. The investor-landlord, in effect, takes a stake in the success of the tenant's business and shares its ups and downs. Whether it is a hardware store, a furniture store, an ice cream and confections store, a supermarket, or a variety store, the percentage rental will depend on the turnover of merchandise, the margin of profit, and the cost of operating the business.

The method of calculating the amount of the percentage rent must be simple and as foolproof as possible. This will reduce the chance for arguments and disputes. Accordingly, rather than using net profit (a term replete with potential for disagreement) as the yardstick, the figure used is gross sales, gross receipts, or gross revenue. The term "gross sales"

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should be clearly defined as, for example; all sales made at or from the leases premises, whether for cash or credit, whether by the tenants or subtenants, minus refunds for returned merchandise and minus sales taxes. The tenant usually must calculate the gross sales figure and the landlord is allowed the right to examine the books and records which pertain to the gross sales figure.

The Seasonal Business

The percentage rental payable by a seasonal business or by a business with known slack months will fluctuate widely and shock an unsuspecting landlord. **Example:** Under a percentage lease, a tenant paid an investor-landlord about $2000 a month from January through May. Then the payment for June was only $200 and for July was only $100. The landlord found out–the hard way–that the tenant's business regularly dropped off as soon as the nearby high school was out and the business would remain low until school again opened in September.

The landlord is well advised to set both a minimum monthly amount of rent and a percentage rental. With any tenant, whose business is seasonal or not, the risk is too great unless there is both a minimum and a percentage rental for the property. There are a number of ways that the rental arrangements can be set to provide both a minimum and a percentage rental:

- A minimum rental plus a fixed percentage (1%) of all the tenant's gross sales each month.
- A minimum rent plus a percentage (1%) of the tenant's gross sales which exceed a fixed number each month (say $50,000).
- A percentage (1%) of gross sales per month but in no month less than a specified minimum rental.
- A percentage (4%) of the first $40,000 of gross sales, then a percentage step-down (of 1%) on each of the next $10,000 of gross sales until the level of gross sales produces a minimum percentage of (1%), which percentage will apply to all subsequent sales in that month.
- When the tenant has a particularly strong bargaining position, the lease may call for a minimum rent plus a percentage rent (1%) on all gross sales, with a ceiling on the maximum monthly rental. ❑

Changes In Shopping Centers

Shopping centers have been changing. Increased spending power in the population is supporting new mall construction and the renovation of existing centers.

Now the newer and renovated centers are becoming more mixed use, with hotels and office buildings being incorporated into the plans. Larger malls are providing more than just shopping. We are seeing more cultural attractions, medical clinics, health clubs, spas, and other facilities locating there.

With the success of the huge mall/amusement centers throughout the country, the idea of combining amusement centers with shopping facilities is becoming more popular. Shopping centers are increasingly becoming "town centers", which is what the original planners had in mind for these facilities in the beginning.

Opportunities For New Thinking

The idea of enclosing a shopping center came about many years ago. Since then there have been many other innovations. We now have super regional malls, high-rise downtown centers, off-price shopping malls, anchorless strip shopping centers, centers with unconventional anchors, fashion centers, mini-malls, shopping center condominiums, underground climate-controlled shopping centers.

Opportunities may abound for the innovator who can make some significant changes in an older, more conventional center. We may be on the brink of a return to urban shopping. The trend could bring three problems:

1. There may be difficult times ahead for the existing older shopping centers.

2. Developers may be overbuilding new suburban shopping centers.

3. The days of the downtown pedestrian shopping mall may be numbered.

Renovation can be the answer to help minimize the hard times for older suburban shopping centers. The renovator might look at the area and ask himself what he would do if he were working with a vacant piece of property - and a new shopping facility was being constructed nearby. He must identify his retail market. Then the existing center can be renovated with the features that will appeal to his particular market today. ❑

Owners & Tenants Must Have Insurance

Insurance coverage must be addressed by both landlords and commercial tenants. For the run-of-the-mill daily problems, a landlord must have the maximum coverage for the building and the tenant's leases. The tenant must cover the business with coverage that will protect his business. What if you have a small disaster that is easily repaired, but you lose a tenant because he was not covered for the damage inside the business?

Consequential Loss Coverage

A fire or other peril may cause a financial loss other than that resulting from direct destruction of the property. Such losses are called "consequential losses" and include those resulting from the loss of use of the property destroyed, such as interruption of business, and property loss from indirect connection with the hazard rather than from direct destruction. The types of insurance against consequential losses include:

- Business interruption insurance.
- Delayed profits insurance, which covers the loss of profits that result from a delay in the completion of the construction.
- Leasehold insurance, which covers a tenant's financial loss if the lease is canceled as a result of fire or other insured peril.

Business Interruption Insurance

A business interruption policy normally embraces both loss of income and "added expense" protection. The latter may be the more important because it reimburses the tenant for the special costs associated with obtaining substitute equipment and (if temporary space is needed elsewhere), the cost of renting such quarters. To the extent that the tenant's profits are adversely affected, notwithstanding the ability to continue operations, protection is furnished by the loss-of-income feature of this coverage.

Business interruption policies can be more effective with appropriate endorsements that enlarge the covered causes of loss and extend the period of indemnity. Two examples are the following:

- **Nonbuilding damage.** The standard policy only covers losses attributable to a casualty to the building itself. If damage extended to telephone and data service lines located outside the building, resulting losses to the tenant would be covered only under an appropriate endorsement to the policy.
- **Extended restoration.** The standard policy limits the indemnity period to the time needed to restore the building to its precasualty condition. This may be less than the time needed for actual restoration, for example, when local law requires the reconstructed building to meet updated code standards. The policy coverage can be extended for this purpose by endorsement.

Lease Termination Insurance

When casualty damage is so extensive that the landlord can cancel the lease, the tenant may incur loss because it is unable to lease elsewhere on comparable terms. Leasehold interest insurance protects against such loss. The loss is equal to the discounted present value of the difference between (1) the rental specified in the lease and (2) the higher market rent for comparable space, projected for the balance of the lease term, including all renewal option periods. ❏

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